FEDERAL ARBITRATION ACT: IS THE CREDIT CARD INDUSTRY USING IT TO QUASH LEGAL CLAIMS?

HEARING

BEFORE THE

SUBCOMMITTEE ON
COMMERCIAL AND ADMINISTRATIVE LAW

OF THE

COMMITTEE ON THE JUDICIARY
HOUSE OF REPRESENTATIVES

ONE HUNDRED ELEVENTH CONGRESS

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FEDERAL ARBITRATION ACT: IS THE CREDIT CARD INDUSTRY USING IT TO QUASH LEGAL CLAIMS?

TUESDAY, MAY 5, 2009

HOUSE OF REPRESENTATIVES,
SUBCOMMITTEE ON COMMERCIAL AND ADMINISTRATIVE LAW,
COMMITTEE ON THE JUDICIARY,
Washington, DC.

The Subcommittee met, pursuant to notice, at 10:10 a.m., in room 2141, Rayburn House Office Building, the Honorable Steve Cohen (Chairman of the Subcommittee) presiding.

Present: Representatives Cohen, Delahunt, Maffei, Lofgren, Johnson, Scott, Franks, Jordan, Smith, Coble, and Issa.

Staff Present: (Majority) Norberto Salinas, Counsel; Adam Russell, Professional Staff Member; and (Minority) Daniel Flores, Counsel.

Mr. COHEN. This hearing of the Judiciary Subcommittee on Commercial and Administrative Law will now to come to order.

Without objection, the Chair will be authorized to declare a recess of the hearing.

I will now recognize myself for a short statement.

Within the last year, we have seen an increase in foreclosures and job losses and a drop in value of retirement accounts. Several congressional Committees have held hearings to determine what caused the economic downturn and what impact the downturn has had on consumers, workers, and businesses.

This Subcommittee recently held a hearing to examine whether the credit card industry's practices are bankrupting Americans. We heard testimony from witnesses that excessive fees and interest rates, unilateral change in term provisions and changes in credit limits have exacerbated the burden borne by credit card debtors. The growing burden, we learned, has pushed some debtors into bankruptcy.

Just last week, Congress passed the Credit Cardholder's Bill of Rights Act in an attempt to shield cardholders from some of the most outrageous practices of the credit card industry. Some of these practices have hindered some cardholders' ability to weather this downturn.

Today's hearing will focus on arbitration and how its use has impacted consumers, specifically credit cardholders. Nearly every credit card issuer includes an arbitration agreement in their terms of use of contracts with cardholders. Arbitration agreements were initially used to free up the courts from an increasingly heavy docket and to allow quicker resolution of the dispute. However, the use of arbitration has expanded from simply involving disputes between commercial parties to issues between consumers and businesses, employees and employers, shareholders and corporations.

As arbitration has increased in popularity, what was once a choice has become a mandatory more or less adhesion part of a consumer contract. In effect, according to the 2004 survey, one-third of all major consumer transactions are covered by mandatory arbitration clauses; and despite all the benefits of arbitration, mandatory arbitration agreements may not always be in the best interest of the consumer.

This hearing will provide Members of the Subcommittee the opportunity to hear testimony about the credit card industry's use of arbitration to resolve disputes with cardholders. We will hear from some witnesses who will speak in favor and some who will speak against.

We will also hear testimony about studies which analyzed arbitration decisions concerning credit card disputes and how those decisions impact the credit cardholder; and Members will consider whether the inclusion of arbitration clauses is beneficial to the credit cardholders or do these clauses simply place an additional burden on the cardholders, many of whom are barely keeping up mortgage or rent payments, insurance premiums, and credit card bills.

So today's testimony and hearing is quite relevant to the distress that many in America are experiencing. Accordingly, I look forward to hearing today's testimony.

I now recognize my colleague from Arizona, Mr. Franks, the distinguished Ranking Member of the Subcommittee, for his opening remarks.

Mr. FRANKS. Well, thank you, Mr. Chairman; and thank you for calling the hearing.

Arbitration is indeed an important topic. We examined it more than once in the 110th Congress, and I would confess that my working conclusion from those hearings is that the theory and evidence both show that arbitration is working well for consumers and that our overburdened court system needs the arbitration system as a vital relief valve. And I therefore am of the view that if we are going to even consider doing anything to reform the arbitration system this term, including with regard to credit card arbitration, we need to do more oversight and ask more questions about whether that is truly needed.

The issue of credit cards and arbitration is a good example of our need for more information. We last considered this specific issue in June of 2007 during our initial hearing on mandatory binding arbitration. At the end of our hearing, there were numerous important open questions. We were able to consider only some of those that might bear on whether reform on the system makes sense.

The first set of questions was about what really is happening in consumer cases that go to mandatory binding arbitration. Are consumers doing well there compared to litigation? Do they receive a fair process? Do they receive timely results? Do they face excessive costs? Are they satisfied with the process, with the system, and the outcome? If there are shortcomings in these areas, are there things we can do to improve mandatory arbitration, rather than to just eliminate it?

A second set of questions concerned voluntary arbitration. If we restrict mandatory binding arbitration, will consumers and businesses be able to use it instead of litigation? Or, instead, will one side or the other inevitably see that litigation gives it the upper hand in such cases if a dispute arises, leading requests for voluntary arbitration to fall on deaf ears? And will the parties who have had the advantage in litigation usually be the businesses which typically have time and money on their side?

Another important set of questions concerns that very alternative to arbitration which is, of course, litigation, particularly class action litigation. For example, can litigation possibly compete with arbitration in its ability to deliver at least some reasonable justice promptly? Will litigation attorneys even take the small-money, small-fee cases that make up so much of the case load in arbitration? And, if they don't, won't that leave millions of working poor Americans with no recourse to justice at all?

More poignantly, with regard to class actions, does the history of class actions in producing pro-plaintiff awards that are little more than peanuts give us any confidence that class actions pave a better path to justice than arbitration? And what does the class action corruption review about the Milberg Weiss scandal tell us? This is where, Mr. Chairman, where prominent class action lawyers were convicted for essentially buying and selling fake evidence and witnesses in class actions. Shouldn't we investigate the corruption of the class action system to the bottom before we hand another huge portion of this country's disputes over to the class action plaintiff's bar?

I could go on, Mr. Chairman, but I suspect that you see the point. There are many, many questions that we must ask, both about arbitration and litigation, before we can reasonably entertain proposals to expand the litigation system at the expense of the arbitration system; and, of course, I am as always eager to hear more information today. I expect that much of that will confirm our already strong reasons to believe that arbitration is often better for consumers and certainly typically no worse than litigation.

And I reserve the balance of my time, it says here, Mr. Chairman.

Mr. COHEN. So reserved. I thank the gentleman for his statement.

I now recognize the distinguished Subcommittee Chairman from the great State of Georgia, Mr. Hank Johnson, a distinguished Member of the Subcommittee, for an opening statement.

Mr. JOHNSON. Thank you, Mr. Chairman; and it is always a pleasure to come back and learn so much from you. I have been sitting at your knee for a long time and listening carefully, so——

Mr. COHEN. You have 7 minutes.

Mr. JOHNSON. All right. And I hope you will continue to allow me to gain some experience, Mr. Chairman.

Ladies and gentlemen, the Federal Arbitration Act, is the credit card cndustry csing the act to slam shut the courthouse door for users? That's our topic today. And, Mr. Chairman, forced arbitration has been a concern of mine for some time; and I firmly believe that Congress must act in this instance to protect consumers.

Credit card users are certainly subject to forced arbitration as employees, cell phone users, and franchisees. My legislation, H.R. 1020, the "Arbitration Fairness Act of 2009," seeks to correct this unfair practice where consumers are forced to sign pre-dispute mandatory arbitration clauses. In the last Congress, we had 103 cosponsors of the bill. This time we have got almost 60.

One of our indelible rights is the right to a jury trial. Guaranteed by the United States Constitution, this right has been gradually eroded through forced arbitration agreements. Just by taking a job or buying a product or service, individuals are required to give up their right to go to court if they believe that they are harmed by the company. According to a recent study, roughly three-quarters of Americans incorrectly believe they could sue an employer or company should they be harmed or have a major dispute that arises, even when they are bound by forced arbitration.

Businesses defend these forced arbitration agreements by arguing that it is cheaper, more informal, and results—an expedited process is the result. But these agreements leave consumers, employees, and small businesses at a distinct disadvantage.

However, the Arbitration Fairness Act does not forbid arbitration clauses. It merely prevents forced pre-dispute arbitration clauses. Consumers may still opt to arbitrate a dispute with a company but only when that consumer determines that it is the appropriate forum at the time the conflict arises and certainly not before.

Forced arbitration appears fair on its face. What could be wrong with being judged by a neutral arbitrator picked by both sides? That's only half the story, though, ladies and gentlemen. Arbitrators tend to favor what we call "repeat players." These are the people who impose the pre-dispute mandatory arbitration on consumers; and so it is not the consumers that refer the business to these arbitrators, it is the businesses. And so they tend to be predisposed, of course, to serve the one that pays them. And that's only human nature.

Arbitration is also expensive, and individuals still must pay exorbitant legal fees for the ability to go into an arbitration process which is stacked against them. These arbitration proceedings may be called 4-, 5,000 miles away from where you live or where the dispute arose. You have got to pay for travel expenses, going out there, hotel expenses.

Arbitration can also be difficult for individuals to navigate. So, oftentimes, you do need an attorney. And, by the way, the corporate attorneys get paid by the hour; and so I think we should have tort reform with respect to the hourly fees that are charged by these lawyers for commercial interests. And I certainly have no problem with lawyers. I am a lawyer myself; and some of my best friends are lawyers—and lawyers on both sides, by the way, defense and plaintiffs.

Importantly—I guess most importantly, Americans are not even aware that they are signing these clauses because they are written in "legalese" and buried in fine print.

Mr. Chairman, once again, thank you for holding this hearing; and I will yield back

Mr. COHEN. Thank you, Mr. Johnson.

Is there somebody on this side that would like to make an opening statement?

I recognize the distinguished gentleman from the Alamo, San Antonio, the Ranking Member of the full Committee, Mr. Lamar Smith.

Mr. SMITH. Thank you, Mr. Chairman.

Let me confess at the outset to having a little bit of a vested interest in the subject today. Long ago and far away, when I was a County Commissioner in San Antonio, Texas, the City of the Alamo, I started the Bexar County Mediation Center, and it has grown and prospered and is considered a real success. So I do believe in that concept to a great extent.

Mr. Chairman, arbitration is vital to this Nation's dispute resolution system. Consistent with fundamental American values, it is fair, low-cost, and easily accessible. It is a beneficial addition to our civil courts which are overburdened, understaffed, and clogged with abusive lawsuits. Further, unlike litigation, it tends to avoid, rather than hasten the destruction of commercial relationships.

Advocates of more litigation, particularly the plaintiff's class action bar, have long sought to eliminate arbitration. Theirs is largely an effort to stamp out the competition that arbitration poses to litigation attorneys.

Today's hearing might also be called a Hearing on Efforts to Void the Federal Arbitration Act: Are Trial Lawyers Trying to Stifle Competition? I hope that is not the case. But bills are pending in Congress to wipe out large areas of arbitration. They are backed by the plaintiff's trial bar; and they are contrary to the clear and growing evidence that consumer arbitration works, is fair, and should be preserved.

Not only that, there is growing evidence that arbitration works better than litigation. One of the witnesses at today's hearing, for example, has just released an important, nonpartisan, peer-reviewed study on consumer arbitration. That study, Consumer Arbitration Before the American Arbitration Association, confirms that arbitration works and works fast for the consumer. It produces mutual settlements or voluntary dismissals in a large share of cases. Consumers win relief in most cases they file. There is no proof that companies are favored over consumers.

Arbitration provides a predictable and low-cost alternative to litigation, particularly a class action litigation with its runaway jury awards. That, in turn, lowers the costs of goods and services; and in this economy, what consumers need are lower cost goods and services, not class action lawyers.

In the credit card sector, lower cost goods and services means more accessible consumer credit at lower interest rates. We should do everything we can to preserve what makes credit cheaper and more valuable in today's economy.

President Obama, less than 2 weeks ago, highlighted the urgent need to make more consumer credit available. He also urged credit card companies to make their contract terms more understandable and more transparent, and he expressed support for curbing some credit card practices alleged to be abusive. But he did not identify credit card arbitration as an abusive practice, nor did he make any suggestion that we should prohibit it.

The preservation of arbitration is consistent with sound economic principles and traditional American values of freedom of contract and self-reliance. If we act contrary to these principles and values, who will benefit? Consumers will not benefit. They will lose access to both a fair means of dispute resolution and cheaper credit. The court system will not benefit. It will be overloaded with cases that arbitrators can resolve more rapidly and less expensively. Taxpayers will not benefit. They will have to shoulder the burden of the court systems' increased demand for resources.

Not even plaintiffs in the new and unnecessary litigation that trial lawyers seek will benefit in the end. It will take longer for them to recover remedies. Their relationships with good companies too often will be sacrificed, and the class actions that anti-arbitration interests promote too often pay pittances in damages or nothing at all.

So who will benefit? Mainly, it will be class action plaintiffs' lawyers who squeeze millions of dollars in fees from their clients' cases.

Let's not let today's hearing mark the day we begin to throw another log on that fire of citizen outrage by sacrificing our arbitration system to the special interest of trial lawyers.

Mr. Chairman, you have been very gracious with the time, and I yield back.

Mr. COHEN. Thank you, Mr. Smith. I appreciate your statement.

Now I would like to recognize a distinguished first-year Member from the State of New York, unlike Mr. Johnson, not a lawyer but a holder of a credit card, Mr. Maffei.

Mr. MAFFEI. Thank you, Mr. Chairman.

Though I must point out to you I cut up my credit card on the floor of the House last week, so—actually, I do have two. My wife wants me to cut up the other one as well.

I commend you for holding this hearing, and I do want to thank the witnesses for being here today. And I want to be clear that I do not oppose the concept of arbitration.

Indeed, Mr. Smith just brought up a very good point. When used appropriately, arbitration can be an extremely useful and effective tool as it offers an ability to settle cases much quicker at a lower cost. However, we do not currently have a level playing field right now; and we must be here and do this kind of hearing to address some of these problems.

The credit card industry, in my view, is one example where businesses have understood the benefits of arbitration and have nearly uniformly included binding arbitration agreements and their contracts. Unfortunately, many have gone beyond the congressional intent of the Federal Arbitration Act and abused the system, effectively tilting the scales of justice unfairly in their favor.

As an example, I would like to tell the story of Anastasia Kamarova, a constituent of mine who was wrongfully hurt by forced arbitration. In February of 2005, she started getting phone calls from debt collectors about a delinquent credit card balance. But what is strange is that she did not even have a card with that company. In fact, when the card was issued, she hadn't owned any credit cards at all. It turned out that the credit card company had the wrong Anastasia, who spelled her name a little differently.

The debt collector continued to pursue the issue, and she was asked to appear before a private arbitrator in Minnesota. Anastasia tried to convince the debt collector that they were targeting the wrong person, but they did not seem to care, and a judgment of over $11,000 was made in favor of the company in this case. This judgment immediately became enforceable in court, even without Anastasia having a chance to defend herself.

Under the Federal Arbitration Act, a court would not be able to reexamine the decision, even though it was clear that she was a victim of mistaken identity or perhaps even identity theft.

So this hearing comes on the heels of the Credit Cardholder's Bill of Rights. For far too long, the scales have been tilted in the direction of the companies. This, in my opinion, is in large part due to the ridiculously broad contracts that virtually all credit card issuers issue that include these arbitration clauses. Indeed, very few of us can say we understand our credit card agreements; and those of us that can say usually understand that they give almost all of the power to the issuers.

I do believe that it is appropriate to have a lawyer when you are buying a house, when you are purchasing a house. But none of us who are not lawyers should need a lawyer there just to get a credit card.

Arbitration was intended to improve access to justice, and we should work to keep it that way and not make it yet another tool to collect money from consumers like Mrs. Kamarova.

I look forward to the testimony from our panel and I thank the Chairman for holding this important hearing, and I yield back the balance of my time.

Mr. COHEN. Thank you. Appreciate your statement.

Without objection, the rules of the Subcommittee are in place that all Members who make opening statements have to stay for the entire hearing.

Without objection, that is done.

I now recognize Mr. Coble for an opening statement.

Mr. COBLE. Thank you, Mr. Chairman. I will be very brief. Thank you for calling this hearing.

Mr. Chairman and colleagues, one criticism that has been brought to my attention alleges that arbitrations are biased; and I would like to hear from the witnesses if they aware of any study or empirical data that would confirm or reject the notion that only arbitrators favorable to the credit card industry oversee these cases on the one hand or, conversely, whether arbitrators favorable to credit cardholders or consumers oversee these cases.

And with that, Mr. Chairman, I yield back the balance of my time.

Mr. COHEN. Thank you, Mr. Coble.

Is there anybody else on the Democratic side who would like to make an opening statement?

If not, anybody on the—Mr. Issa is recognized.

Mr. ISSA. Thank you, Mr. Chairman.

And I, too, am both not a lawyer and have a credit card. But unlike some people, perhaps, I have also been on both sides of arbitration. Arbitration has gotten it right, and then also I have lost. We will consider those, when arbitration got it wrong. But I am an advocate for arbitration.

But more importantly here today, I hope to hear from the witnesses how, in fact, we on the dais seem to have the hubris and those in the White House seem to have the hubris to believe that we can overturn 200 years of contract precedent, that, in fact, what we are talking about here today is depriving an arm's-length relationship between somebody who will extend money to someone with virtually no collateral or no collateral, in most cases, in return for simply a promise that they will pay it back under the terms that they're offered.

In addition to being a credit cardholder, I am the former CEO of a company that expanded our sales by huge amounts based on the reliance on credit card companies. Many of my customers, although all businesses, used their credit cards to extend their credit, sometimes as much as $100,000 in credit cards that they would run up in purchases of my company's products.

I signed a contract. I didn't like the contract because the contract left the credit cardholder in a position where they could dispute a bill and I would be immediately debited back. Ultimately, we had a system of arbitration if we felt that was unjust, but in fact that was part of the deal. We accepted that because it expanded our business, and we did so voluntarily and entered into the many contracts. My companies that bought my products entered into their contracts.

What we are talking about here today is preempting the ability for companies to offer a contract and individuals to choose that contract. We do so at our peril.

Just as I believe the preemption of bankruptcy in the Chrysler case and a great many other things today cause people around the world to question whether we are, in fact, a constitutional republic where the rule of law is predictable or whether or not we will simply, from time to time, for convenience, intervene with contracts longstanding.

With that, I yield back.

Mr. COHEN. Thank you, Mr. Issa.

If there are no other Members seeking to make an opening statement, they may submit a statement to be entered into the record.

I am now pleased to introduce the witnesses and hear their testimony for today's hearing. Thank you all for participating in today's hearing. Without objection, your written statement will be placed in the record; and we ask that you limit your oral remarks to 5 minutes.

You will note we have a lighting system here. Red is the end, yellow you have got a minute to go, and green you're on your phone for 4 minutes.

After each witness has presented his or her testimony, Subcommittee Members will be permitted to ask questions, also subject to that 5-minute limitation.

Our first witness is Michael Donovan. Mr. Donovan is a founding member of the law firm Donovan Searles. Following graduation from Vermont Law School, Mr. Donovan was a trial attorney with the SEC in Washington, prosecuted numerous securities cases and enforcement matters, including injunctive and disciplinary actions against public companies, broker dealers, and accounting firms. He has co-authored many publications, including Preserving Judicial Recourse for Consumers: How to Combat Overreaching Arbitration Clauses.

Mr. Donovan has appeared as a faculty member and speaker at the ABA's Class Action Forum, the Consumer Credit Regulation Forum of the New Jersey Bar, National Consumer Rights Litigation Conference sponsored by the National Consumer Law Center, is a member of the ABA and the Chair of the Consumer Law Subcommittee of the ABA Litigation Section's Class action and Derivative Suit Subcommittee. He is also the former Vice Chair of the National Association of Consumer Advocates and an active member of the Trial Lawyers for Public Justice.

And I guess all that makes you a plaintiffs' class action lawyer. Thank you, Mr. Donovan. You may begin your testimony.

You need to press a button, I guess. Is that the button? You need to turn on the clock.

TESTIMONY OF MICHAEL D. DONOVAN, ESQ., NATIONAL ASSOCIATION OF CONSUMER ADVOCATES

Mr. DONOVAN. Let me start by answering directly the question presented by the title for this Subcommittee hearing. Yes, the credit card industry is using forced arbitration and the Federal Arbitration Act to quash legal claims by ordinary consumers that are in each of your districts.

Congress must pass the Arbitration Fairness Act sponsored by Congressman Johnson in order to stop the misuse of Federal law to deny the due process rights of my clients and every one of the American citizens represented by this panel.

In 2007, I appeared before the Senate Banking Committee to discuss the problems with the credit card industry. I described the many abuses imposed upon my clients and your constituents by the unfair practices of the credit card industry.

Let me point out, Congressman Issa, that the one difference between the credit card contract and 200 years of contract law in this country is that the credit card contract, unlike any other common law contract with which we are familiar, includes a unilateral change in terms provision that allows the stronger party, the party with more power, to unilaterally change the terms of that contract at any time, for any reason, to impose any penalty, charge, fee or term that it wants; and the credit card companies have used this abusive change in terms provision over and over and over again.

No other contract in American history has ever included that type of unilateral change in term provision without notice. And the card companies are using those provisions today to impose unfair penalty rates, trip-wire pricing, tricks, traps, reverse promotional offers, undermine promotional offers and, yes indeed, to impose unfair arbitration clauses in which they can sue and have sued my clients in distant fora.

In fact, most of the credit card industry now uses an arbitration forum that is, in fact, biased. It is biased because we know from arbitrators who have worked for this forum that it is a biased forum. The name of the forum is the National Arbitration Forum. It is located in Minnesota; and it frequently conducts unfair, on-the-paper arbitrations in which it enters judgment unilaterally against consumers, as Mr. Maffei's constituent experienced. That Forum unilaterally entered a mistaken arbitration award against his constituent when, in fact, that constituent never even had a contract allowing that Forum to perform arbitration.

Now, is that a unique experience? Does that happen rarely, infrequently? It happens every day. The Web sites are littered with tens of thousands, hundreds of thousands of complaints about credit card practices, abuses, deceptive misconduct.

Let me start with an example. One example is the notorious In Re Providian Bank. Its credit card portfolio was purchased by Washington Mutual. It is now owned in part by JPMorgan Chase.

What did Providian Bank do? Well, Providian Bank was the target of a class action litigation. Yes, I was involved in the class action litigation. Guess what the class action litigators found in litigating this frivolous case? The reality of it is is what they found was that Providian Bank had embedded in the bar codes of its return payment information, those bar codes on the bottom that you send your check in with, intentionally embedded the wrong zip code in order to ensure that the payments cardholders sent in would be late so that Providian could increase its late fee revenues. That is what the class action lawyers found.

And Providian Bank, the reason why they did that was because Providian had already sold off its rights to the interest that people would pay on those credit card receivables. But for the late fees, Providian got to keep those as revenues and could report them to their shareholders as higher revenues.

So this is what the class action lawyers found, was that this conscious deceit, fraud, deception, was performed by Providian on its own cardholders. Why did it perform this? To increase its revenue, inflate its stock price, and award higher bonuses to all these Wall Street titans. That is what Providian did.

What happened in the Providian case? Well, the class action was settled for $105 million. Yes. On a per member basis, is that a lot of money? Do people only get back $30? Sure they only get back $30 because that is how much they were overcharged. That was the late fee.

They also had to pay penalties because the OCC, their regulator, came in late. The OCC has been an abomination. They do not regulate banks. They are owned by the banks. In fact, the banks pay almost all of their budget. In fact, people choose——

I am over my time. I am sorry.

Mr. COHEN. Mr. Donovan, somehow or another, you didn't get to go to yellow. So what we will do is split the difference and give you 30 seconds.

Mr. DONOVAN. Very good, and I apologize. Congressman, it is my temptation as a trial lawyer to call just about everybody Your Honor. So if you will permit me that informality——

Mr. COHEN. You are down to 17 seconds.

Mr. DONOVAN. In any case, the fact of the matter is, in the absence of class actions for these small value claims in which consumers cannot ever gain access to court, you will have tens of thousands of credit card companies continuing to engage in massively abusive practices which everyone in the United States knows is ongoing and will continue to be ongoing, particularly with arbitration.

Thank you.

Mr. COHEN. Thank you, Mr. Donovan. I appreciate your testimony and your appellation.

[The prepared statement of Mr. Donovan follows:]

PREPARED STATEMENT OF MICHAEL D. DONOVAN

Written Testimony

Of

Michael D. Donovan

Partner

DONOVAN SEARLES, LLC
PHILADELPHIA, PA

also on behalf of

The National Association of Consumer Advocates

Before the

HOUSE SUBCOMMITTEE ON COMMERCIAL AND ADMINISTRATIVE LAW, COMMITTEE ON THE JUDICIARY

Hearing on the "Federal Arbitration Act: Is the Credit Card Industry Using the Act to Slam Shut the Courthouse Door?"

May 5, 2009

INTRODUCTION

Chairman and members of the Committee, thank you for the opportunity to speak about some of the current abuses in the credit card industry and to describe the problems and experiences of the everyday consumers I represent in Pennsylvania and elsewhere. This testimony also is presented on behalf of the National Association of Consumer Advocates.[1]

I started my career in 1984 as a trial and appellate attorney at the Securities and Exchange Commission here in Washington, D.C. After working at the Commission, I entered private practice at a firm in Philadelphia, PA. Since about 1993, I have concentrated my practice on consumer matters, which has included cases challenging credit card company practices, cases against debt collectors for violations of the Fair Debt Collection Practices Act, cases against predatory lenders for unfair and deceptive lending practices and cases against finance companies for bait and switch schemes and illegal loan packing.

I argued before the U.S. Supreme Court in the case of *Smiley v. Citibank*, which concerned whether late fees are "interest" under the National Bank Act. I also obtained a landmark decision from the Third Circuit Court of Appeals in *Rossman v. Fleet Bank*, holding that the Truth in Lending Act prohibits bait and switch marketing schemes and does not allow a credit card issuer to change a "No Annual Fee" card to an annual fee card, at least within the first years after the card was issued. I am one of the co-chairs of

1 The National Association of Consumer Advocates (NACA) is a non-profit corporation whose members are private and public sector attorneys, legal services attorneys, law professors, and law students, whose primary focus involves the protection and representation of consumers. NACA's mission is to promote justice for all consumers.

the Consumer Law Subcommittee of the American Bar Association's Litigation Section and I am a former chair of the National Association of Consumer Advocates.

REAL WORLD CREDIT CARD NIGHTMARES

In February 2007, I appeared before the Senate Banking Committee where I described several of the real world credit card nightmares my clients had encountered. Rather than repeating that testimony here, allow me to catalogue a number of the widespread abuses engaged in by nearly all if not all of the credit card issuers in the past ten years. I believe this list will make it abundantly clear that the credit card industry has used and is using forced arbitration and the Federal Arbitration Act not to resolve disputes cheaply, quickly and informally but instead as a "get of jail free card" that effectively immunizes the industry from any realistic scrutiny or restitution for its illegal practices. As courts, commentators and consumers have all recognized, Congress must step in to eliminate this misuse of the Federal Arbitration Act by passing the Arbitration Fairness Act, HR 1020, as soon as possible.

In re Providian Credit Card Class Actions. The poster child for credit card abuse is Providian Bank, whose credit card portfolio was acquired by Washington Mutual and is now owned in part by JP Morgan Chase. In the late 1990s, consumer advocates and class action lawyers filed cases alleging that Providian had charged customers for various fee-based products without getting customer consent. *See, e.g., In re Providian Financial Sec. Litig.*, 152 F. Supp. 2d 814 (E.D. Pa. 2001); *see also In re Providian Credit Card Cases*, 2003 WL 23002628 (Cal. App. 1st Dist. 2003). Among other things, Providian charged for credit protection insurance, which it claimed would help hospitalized or unemployed customers avoid credit card payments, without receiving customer consent for the product. It also failed to post payments in a timely manner, imposed late fee charges when the payments were not late, failed to provide promised promotional rates to balance transfers, reneged on promised minimum payment terms and aggressively steered credit card customers into subprime home equity loans. During the course of the litigation, the class action lawyers discovered that Providian intentionally had embedded the wrong zip code into the bar codes for the return bill payment envelopes to ensure that customer payments would be delayed and thereby increase the late fee revenues Providian could charge and collect. Eventually, Providian settled these claims along with claims that were asserted by the San Francisco District Attorney's Office and the Office of the Comptroller of the Currency. Providian agreed to pay $105 million in restitution cash and credits to settle the class actions and $200 million to settle the regulator claims.

***Rossman v. Fleet Bank*, 280 F.3d 384 (3d Cir. 2002).** Fleet Bank, which eventually became Sovereign Bank, solicited new credit card customers by mailings and other solicitations that promised a low rate and "no annual fee." Within months after consumers signed up for and started using the card, Fleet sent around a "change in terms" notice stating that it would charge an annual fee in the next billing statement. A number of class actions were filed, and the Court of Appeals in Philadelphia eventually ruled that Fleet had engaged in a "bait and switch" scheme by using its "change in terms" clause to contradict the express commitment it had made in the credit card solicitation. Fleet settled these claims by agreeing to reimburse and credit the annual fee it had improperly charged and collected from cardholders.

***In re Advanta Credit Card Class Actions*.** Advanta is another aggressive credit card issuer that was forced to change its practices by class action litigation. Advanta had promised a guaranteed fixed rate of 9.9% on its credit cards. Despite that guarantee, it unilaterally increased the purportedly "fixed rate" to 17%. After class lawsuits were filed, Advanta agreed to settle for $11.75 million in restitution and credits paid to the cardholders.

Spark v. MBNA. MBNA is another credit card issuer that changed at least some of its practices in response to class action litigation. Like many credit card issuers, MBNA offered low promotional rates to cardholders for balance transfers. The low promotional rates would apply to the transfers while higher, normal rates would continue to apply to purchases on the card or on fees charged to the card. MBNA did not disclose, however, that it would apply payments made by the cardholder first to the lower rate balances and then to the higher rate balances. The economic effect was to nullify the financial benefit of the promotional rate, as the higher rate balances would grow under a higher rate, at least until the balance transfer was paid off. Again in response to class litigation, MBNA changed this practice and paid restitution to the cardholders who were misled by this marketing trick.

Yu v. Signet Bank. Signet Bank, which ultimately became Capital One, was one of the first credit card issuers to engage in the due process violation known as "distant forum abuse." Relying on the Virginia choice of law clause in its credit card agreement, Signet would file debt collection cases in Virginia against thousands of consumers residing in California, Washington state and other distant locales. Naturally, Signet would obtain a default judgment against the cardholder, which it would then use to obtain a wage and or tax return garnishment. By engaging in this abuse, Signet effectively prevented cardholders from disputing the claims. In 2003, a California appeals court found that valid class claims had been asserted against Signet for engaging in deceptive debt collection practices. Signet, now Capital One, eventually settled the claims for significant monetary payments and credits to the affected class members. Notably, many card issuers are now using arbitration before the National Arbitration Forum as another form of "distant forum abuse" for the collection of credit card debts. This is an even more severe problem, because victims of identity theft have been caught up in this abusive form of debt collection and have been unable to defend themselves.

In re Chase Bank Check Litigation. Dozens of class actions have been filed against Chase alleging breach of contract and Truth in Lending violations in connection with its promotional rate offers. According to the consumers, Chase promised a low promotional rate of 3.99% for the life of the balance owed for bank check transfers, but then imposed a monthly account service fee and increased minimum monthly payment terms which could only be reversed if the consumer agreed to a higher, non-promotional rate on the transferred balance. While Chase represented that "Your APRs will not be impacted by this change," its own account statements reflected that the effective APR went from "3.99%" before the change to "3,409.09%" after the change. Class action suits are now awaiting consolidation by the Multidistrict Litigation Panel.

American Express Flight Insurance Premium Cases. For many years, American Express offered flight and baggage insurance for a relatively small charge added to the card account for travelling American Express cardholders. When flights and travel were cancelled, however, AMEX would not reverse the charge even though no insurable event or occurrence had or would arise. Given this refusal, a class action was filed to compel AMEX to return the premium payments it unlawfully kept despite having provided no service or insurance. AMEX initially settled the class action, but the court then concluded that AMEX had misled it. AMEX then attempted to compel arbitration of the claims, which the Court rejected on the ground that AMEX had waived its right to arbitration by engaging in litigation and attempting to settle the claims in court. *See Aviation Data, Inc. v. American Express*, 152 Cal. App. 4th 1522, 62 Cal. Rptr. 3d 396 (Cal. App. 1st Dist. 2007).

Foreign Currency Conversion Cases. Class actions also have achieved major changes in the way in which Visa, Mastercard and the bank card issuers charge foreign currency conversion fees for overseas usage of credit cards. Again, dozens of cases were filed alleging that card issuers had violated antitrust laws by agreeing to set foreign currency conversion fees and terms in their membership agreements with Visa and Mastercard. These fees and terms were not set in a competitive market and had no relationship to the actual costs associated with a currency conversion. Visa and Mastercard have agreed to settle these class claims, and final approval of the class settlements is awaiting a decision by the federal district court in New York.

Merchant Interchange Fee Litigation. Small businesses and merchants have also benefitted from credit card class actions. The Merchant Interchange Fee cases were settled for over $3 billion, and forced the industry to drop its "accept all cards" requirement. Wal-Mart was the lead plaintiff in those cases, see *Wal-Mart Stores, Inc. v. Visa U.S.A. Inc. (In re Visa Check/MasterMoney Antitrust Litig.)*, 280 F.3d 124, 140 (2d Cir. 2001) (certifying merchant class); *Wal-Mart Stores, Inc. v. Visa USA, Inc.*, 396 F.3d 96, 103 (2d Cir. 2005) (approving class action settlement).

Payment Posting Credit Card Class Actions. The Fair Credit Billing Act and regulations issued under the Truth in Lending Act require credit card issuers to promptly post a payment to the customer's account as of the date of receipt. *See* 15 U.S.C. § 1666c; 12 C.F. R. § 226.10. Despite this law, nearly every credit card issuer had adopted payment posting practices that did not post payments on the day received if they were received after a certain time in the day, such as 1:00 p.m., for example, or even as early as 9:00 a.m. Although these deceptive practices increased late fee, overlimit fee and finance charge revenues by millions of dollars for the banks, for any one customer the practice typically resulted in only a small additional charge of about $30 and unnecessary aggravation, which alone would be hardly enough to commence individual suit or an individual arbitration. Dozens of credit card issuers were sued in class actions over these illegal posting practices and were compelled to change the practice and reimburse cardholders for the late fees and finance charges that were collected as a result of the violations. *See, e.g., Mangone v. First USA Bank*, 206 F.R.D. 222 (S.D.Ill. 2001) (approving $39 million settlement). In the absence of this class litigation, it is a virtual certainty that the banks would have continued to ignore federal law. In fact, many banks used arbitration as a primary defense to the claims.

Penalty Fees/Default Accounts/Unfair Change in Terms. Internet websites, blogs and forums reflect tens of thousands of consumer complaints about fraudulent, unfair and deceptive practices by credit card companies. Among other things, consumers complain that card issuers change the payment due dates or the payment P.O. Box without notice, thus forcing late payments and the imposition of sky-high penalty interest rates. They also complain that issuers fail to send out monthly billing statements, which again causes consumers to incur late and overlimit fees and confiscatory penalty interest rate charges. Other complaints focus on the imposition of universal default charges that have no relation to the cardholder's payment history on the specific account in question. The underlying theme in many of these complaints is that the credit card industry is abusing the "change in terms" clause of the cardholder agreement to impose trip-wire, spring-gun pricing that makes it impossible for even a conscientious consumer to meet her obligations or to assess the true costs of credit.

Scores of commentators, academics and even a few industry veterans have observed that the industry has become a "Frankenstein monster" addicted to "tricks and traps" that make it impossible for honest market competitors to compete on a level playing field. To protect this broken market, the credit card industry has turned to arbitration to both deflect the attention of class action consumer advocates and reduce the costs associated with the industries bad practices. Virtually every credit card issuer now includes some form of forced arbitration clause in its credit card agreement. As one court has observed with respect to the GM credit card, a banker "with a brief case can steal more than a hundred men with guns." *See Atlantic Credit and Finance, Inc. v. Giuliana*, 829 A.2d 340, 344 n.3 (Pa. Super. 2003) (quoting Mario Puzo, *The Godfather* p. 51 (Putnam 1969)).

HOW THE CREDIT CARD COMPANIES USE FORCED ARBITRATION TO DEPRIVE CONSUMERS OF DUE PROCESS AND ACCESS TO THE COURTS

Many credit card companies and debt buyers are now using forced arbitration clauses to circumvent basic due process protections and to obtain default judgments against consumers in distant forums. These debt collectors typically use a Minnesota arbitration company, the National Arbitration Forum ("NAF"), to rubber stamp their unsubstantiated debt collection claims. As detailed in the attached materials, the NAF is a more than willing participant in these schemes because it has been paid millions in fees by the credit card companies and has even marketed its services as way to increase recoveries from allegedly defaulted debts.

Let me explain some of the real world problems from this feudal if not corrupt NAF system of debt collection by sham arbitration. With judicial debt collections there are well-established rules that assure proper service of process, notice, an opportunity to be heard, an opportunity to appeal and an opportunity to vacate clearly improper judgments. These requirements put the burden on attorney debt collectors to ensure that they have the right party, that process has been properly served and that evidence supporting the claim and the calculation of the debt owed has been assembled and will be presented to the court before judgment can be entered. These well-established systems and processes have engendered confidence in consumers and creditors alike, serving the country well for more than a century.

With debt collection by forced arbitration, the rules – to the extent they exist – are unenforceable, biased and easily circumvented by repeat player debt buyers, debt collectors and their captive arbitration providers. Proof of service of process, for example, is not filed with a court; it is filed with the arbitration provider to whom the debt collector has just paid an arbitration fee. When the credit card debtor fails to respond to the alleged claim, the NAF simply enters a default award in favor of the credit card company, which is then enforceable in court without the consumer having any chance to defend. Under the Federal Arbitration Act, a court cannot reexamine this decision, even if the alleged debtor was a victim of identity theft who never received the original arbitration demand, never signed any arbitration agreement and never had any true connection to the alleged debt.

This very scenario has played out thousands of times throughout the country. For example, one credit card company obtained default judgments against dozens of consumers from the NAF that they attempted to have enforced by the Pennsylvania courts. The state courts found that the method of service for the arbitrations and the distant forum did not comply with basic due process rules, analogizing the arbitrations to long-outlawed confessions of judgment. The courts then proposed and adopted a rule requiring such collection matters to first be filed in court. Instead of complying with this rule, the credit card companies are now asking the federal courts to enforce their default arbitration awards. The credit card companies are even arguing that the Federal Arbitration Act prohibits federal courts from examining whether NAF or the creditor claimants actually complied with due process.

Other courts have concluded that the prohibition of class actions is unconscionable. In truth and in economic reality, few if any consumers can take on an allegedly deceptive credit card practice individually. The stakes are just not high enough for any one consumer, and the time commitment alone far outweighs any potential economic award. No lawyer can handle an individual consumer credit card complaint, because his or her factual investigation will nearly always exceed in time and money the amount that could be recovered for the individual consumer.

CREDIT CARD COMPANIES HAVE CONSPIRED TO INCLUDE FORCED ARBITRATION IN ALL CARDHOLDER AGREEMENTS.

As a recent decision by the Second Circuit Court of Appeals recognized, virtually all of the major credit card issuers mandate forced arbitration. *See Ross v. American*

Express Co., 547 F.3d 137 (2d Cir. 2008). They include this mandate in the fine print of the cardholder agreement and typically specify the NAF as the required arbitration forum. Industry participants had meetings, typically at bar association conferences, in which they all agreed to include the forced arbitration clauses in their consumer contracts. Lawyers, including those from the NAF, persuaded the card issuers to mandate arbitration ostensibly to lower debt collection and litigation costs, prevent class actions, and blunt all consumer and regulatory challenges to their marketing, payment application and default fee practices.

FORCED ARBITRATION IS, IN FACT, FAR MORE EXPENSIVE FOR THE CONSUMER CREDIT MARKET AND THE U.S. ECONOMY IN GENERAL.

Although card issuers and several courts have touted the purported speed, efficiencies and lower costs associated with forced arbitration, the truth is that it is far more expensive for consumers, the consumer credit market and the overall U.S. economy. Forced arbitration hides important information from the marketplace and unfairly exploits the lack of information consumers have or can obtain about their rights and obligations. Forced arbitration enables card issuers to implement and perpetuate unfair and deceptive card fee and collection practices without any risk of commensurate cost or punishment. For example, card issuers can and have implemented unlawful change of terms provisions, unauthorized or improper fees, and unsubstantiated arbitration awards against non-debtors. Having been implemented by computer program, the bad practices are by necessity widespread. Forced arbitration therefore allows bad issuers to keep the bad practices secret because few consumers know how to challenge them, and those who do may be bought off individually during the secret arbitrations.

Congress has recognized in other consumer contexts that "It is difficult for a company to conform to high standards and practices if it has competitors who continue to reap greater profits by pursuing less honorable tactics." *See*, *e.g.*, Sen. Rep. No. 93-151, *reprinted in* 1974 U.S.C.C.A.N. 7702, 7709. Because forced arbitration allows bad issuers to avoid the true costs of their misconduct, it necessarily hurts good issuers, because they lose market share and, in turn, are forced to engage in the same sharp or dishonest practices or to exit the business altogether. This also hurts consumer confidence because cardholders are unable to distinguish between the good issuers and the bad and, therefore, refuse to pay a premium price or retain their long-held accounts for fear that even a good issuer will engage in the practices or unilaterally change the terms with little or no notice.

Forced arbitration also dramatically increases investor risks, the costs of capital and taxpayer liabilities. As the Providian litigation demonstrates, direct investors in banks as well as purchasers of securitized debt obligations backed by credit card receivables require accurate and timely information about the true risks associated with an issuer's credit card portfolio. Forced arbitration hides from the market material information about these risks. For example, where an issuer has inflated revenues and receivable balances by falsely charging late fees, overlimit fees and credit protection fees or by mis-programming payment processing times or computers, investors cannot fairly price the securities and will suffer unavoidable harm when the true facts are eventually disclosed. In the long run, this lack of transparency in the market causes all investors to distrust credit card backed securities, which increases the costs for even honest market competitors. This, in turn, elevates all market costs and imposes an astronomical fraud and deceit tax on the U.S. economy.

CREDIT CARD CLASS ACTIONS ARE ESSENTIAL FOR DETERRENCE

Recently, legal commentators have rediscovered the important market mechanism that provided the original foundations for the modern class action. *See generally* Myriam Gilles and Gary B. Friedman, *Exploding the Class Action Agency Costs Myth: The Social Utility of Entrepreneurial Lawyers*, 155 U. Pa. L. Rev. 103 (2006). As with the Nobel economist George Akerlof in 1970,[2] these commentators have re-emphasized what originally had been obvious but had become obstructed due to the growth in class litigation and its defense: that the original and most important purpose of the modern class action is deterrence. *See id.* at 108-109, *citing* Harry Kalven, Jr., & Maurice Rosenfeld, *The Contemporary Function of the Class Suit*, 8 U. Chi. L. Rev. 684, 686 (1941). They argue that "[t]he extravagant attention lavished on class member compensation and agency costs in small-claims class actions over the past twenty years has been misguided." 155 U. Pa. L. Rev. at 131. They argue further that much of the recent criticisms of class actions and class action attorney fees "is plain old-fashioned hypocrisy," driven by economic interests motivated to eliminate or diminish the efficacy of class actions. The key, they say, is not to lose sight of "Richard Posner's 1972 observation, regarding class actions, that 'the most important point, on an economic analysis, is that the violator be confronted with the costs of his violation – this achieves

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2 *See* Akerlof, George A., "The Market for Lemons: Quality Uncertainty and the Market Mechanism," 84 *Quarterly Journal of Economics*, 488-500 (Fall 1970), *cited by O'Keefe v. Mercedes-Benz USA, LLC*, 214 F.R.D. 266, 299 n.32 (E.D. Pa. 2003) (approving nationwide class action settlement); *see also California Dental Ass'n v. F.T.C.*, 526 U.S. 756, 771 (1999) (discussing quality and pricing asymmetries between doctors and patients)..

the allocative purpose of the suit – not that he pays them to his victims.'" *Id.* at 162 (quoting Richard Posner, ECONOMIC ANALYSIS OF THE LAW 22 (1972)).

THE ESCALATING PROBLEMS WITH CREDIT CARD DEBTS

The Industry and its Abuses Keep Growing

As the above demonstrate, a significant amount of the debt load facing American households is caused not so much by consumer borrowing, but by the harsh – and exorbitantly expensive – tactics of the credit card industry. A significant contributor to the snowballing credit card debt of American consumers is the enormous increase in both the number and amount of non-periodic interest fees charged by credit card issuers. These "junk" fees include both fees considered to be finance charges (cash advance, balance transfer, wire transfer fees) and non-finance charge "other" fees. Most important among the latter are late payment and over-limit fees. Other abuses include penalty interest rates (where rates are raised due to late payments or exceeding credit limits on the card, or simply if the consumer's credit score decreases below a certain number), deceptive marketing and establishing cut-off times for payment postings that cause borrowers to incur a late fee even if the payment arrives on its due date (for example, by posting all payments at 11 a.m. so that any payment received in the afternoon mail is considered late).

From 1978 to 1995, credit card debt increased six-fold to $378 billion.[3] In 1996, the Supreme Court paved the way for credit card banks to increase their income stream even more dramatically. In *Smiley v. Citibank (South Dakota), N.A.*, the court approved

[3] *See* Fed. Res. Bull., *available at* http://www.federalreserve. gov/releases/g19/hist /cc_hist_mt.txt.

of the Office of Comptroller of Currency's definition of interest that included a number of credit card charges, such as late payment, over-limit, cash advance, returned check, annual, and membership fees.[4] As a result, national banks and other depositories can charge fees in any amount to their customers as long as their home-state laws permit the fees and so long as the fees are "interest" under the Office of the Comptroller of the Currency ("OCC") definition. Uncapping the amount of fees that credit card banks can charge nationwide has resulted in the rapid growth of and reliance on fee income by credit card issuers.

After *Smiley*, banks rushed to increase late charges, over-limit fees, and other charges. The average late payment fee has soared from $14 in 1996 to over $32 in 2004.[5] Over-limit fees have similarly jumped from $14 in 1996 to over $30 in 2004.[6]

Now, banks impose these fees not as a way to curb undesirable behavior from consumers – which used to be the primary justification for imposing high penalties – but as a significant source of revenue for the banks. Since *Smiley*, penalty fee revenue has increased nearly nine-fold from $1.7 billion in 1996 to $14.8 billion in 2004.[7] The income from just three fees – penalty fees, cash advance fees and annual fees – reached

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[4] Smiley v. Citibank (S.D.), Nat'l Assn., 517 U.S. 735, 116 S. Ct. 1730, 135 L. Ed. 2d 25 (1996). The OCC definition of interest is found in 12 C.F.R. § 7.4001(a).

[5] Cardweb.com, *Late Fees* (Jan. 28, 2005), *at* http://www.cardweb.com/cardtrak/news/2005/january/28a.html.

[6] Cardweb.com, *Over-limit Fees* (Feb. 2, 2005), *at* http://www.cardweb.com/cardtrak/news/2005/february/2a.html.

[7] Cardweb.com, *Fee Party* (Jan. 13, 2005), *at* http://www.cardweb.com/cardtrak/news/2005/january/13a.html.

\$24.4 billion in 2004.[8] Fee income topped \$30 billion if balance transfer fees, foreign exchange, and other fees are added to this total.[9] Concurrently, card issuer profits, though declining somewhat between 1995 to 1998, have steadily increased between 1999 and 2004. These profits rose from 3.1% in 1999 to 4.5% in 2004.[10] Not only has the size of fee income for credit card issuers grown enormously, the types of fees have mushroomed as well. The Federal Reserve Board provides a list of fees to consumers in a brochure titled "Choosing a Credit Card."[11] The most common fees incurred in credit card transactions include:

NAME OF FEE	DESCRIPTION OF FEE
Annual fee (sometimes billed monthly).	Charged for having the card. Fees range from zero to \$130.
Cash advance fee.	Charged when the card is used to obtain a cash advance; the fee is usually 3% of the advance, with a minimum of \$5 and no maximum.
Balance-transfer fee.	Charged when the consumer transfers a balance from another credit card. Fees range from 2% to 3% of the amount transferred, with a minimum.
Late-payment fee.	Charged if the consumer's payment is received after the due date. Fees range from \$10 to \$49.
Over-the-credit-limit fee.	Charged if the consumer goes over the credit limit. Fees range from \$10 to \$39.
Credit-limit-increase fee.	Charged if the consumer asks for an increase in her/his credit limit.
Set-up fee.	One-time fee, charged when a new credit

8 *Id.*

9 *Id.* If merchant-paid fees are combined with consumer-paid fees, the total fee income is estimated at \$50.8 billion.

10 Cardweb.com, *Card Profits 04*, (Jan. 24, 2005), at http://www.cardweb.com/cardtrak/news /2005/january/24a.html.

11 Federal Reserve Board, *Choosing a Credit Card*, at http://www.federal reserve.gov/pubs/shop

	card account is opened.
Return-item fee.	Charged if the consumer pays the bill by check and the check is returned for non-sufficient funds.
Expedited payment fee.	Charged when the consumer makes a payment over the phone. Fees range from $10 to $14.95.
Expedited delivery fee.	Charged when the consumer requests an additional credit card and requests that it be delivered in an expedited way.
Replacement card fee.	Charged when the consumer's credit card is lost, stolen, damaged, or otherwise needs to be replaced.
Additional card fee.	Charged when the consumer requests a card for a family member or otherwise wishes an additional card.
Other fees.	Some credit card companies charge a fee to cover the costs of reporting to credit bureaus, reviewing the consumer's account, or providing other customer services.

The problem with these punitive charges, especially in combination with the penalty interest rates, is that they exacerbate the problems of consumers who have hit hard times. Too often these charges drive consumers into bankruptcy, resulting in cascading losses to individuals, families and neighborhoods—of lost savings, lost homes, forced moves, with all of the consequential financial and emotional tolls.

It is not just one or a handful of credit card companies that engage in abusive practices, but a great number of the top ten credit card issuers.[12] It is this pattern of heavy-handed and manipulative conduct by an entire industry that shows that credit card issuers have altered their fundamental treatment of consumers from a fair, respectful business relationship to an abusive, exploitative one.

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[12] For example, *see* information about the civil penalties assessed against Providian and other issuers, http://www.pirg.org/consumer/bankrupt/bankrupt2.htm; and the recent suit initiated against Capital One by the state of Minnesota, http://www.ag.state.mn.us/consumer/PR/PR_041230CapitalOneBank_FSB.html.

Credit card companies were not always so free to engage in reprehensible behavior. Credit card deregulation, and the concomitant spiraling credit card debt of Americans, began in 1978, with the Supreme Court's decision in *Marquette National Bank of Minneapolis v. First of Omaha Service Corp.*[13] This case gave national banks the green light to take the most favored lender status from their home state across state lines, and preempt the law of the borrower's home state. As a result, national banks and other depositories established their headquarters in states that eliminated or raised their usury limits, giving them free rein to charge whatever interest rate they wanted.[14] Therein lies the reason why so many of those credit card solicitations sent by mail every week come from Delaware or South Dakota: credit card issuers moved there to export those unregulated states' *lack* of consumer protections nationwide.[15] As of 1978, credit

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[13] *Marquette Nat'l Bank of Minn. v. First of Omaha Serv. Corp.*, 439 U.S. 299, 99 S. Ct. 540, 58 L. Ed. 2d 534 (1978).

[14] Other depository institutions obtained the same most favored lender status when Congress enacted § 521 of the Depository Institutions Deregulation and Monetary Control Act of 1980 (codified at 12 U.S.C. § 1831d).

[15] South Dakota and Delaware, at the beginning of the explosive growth of the financial services industry around 1980, sought to attract that industry as part of their economic development strategy. They wanted to "provide [their] citizens with the jobs and benefits a large national credit card operation can provide (attracted by the ability to export limitless credit card rates to other states)," while, it should be noted, protecting their local banks from competition with the exporting banks. *Indep. Cmty. Bankers' Ass'n of S.D. v. Board of Governors, Federal Reserve Sys.*, 838 F.2d 969, 975 (8th Cir. 1988). *Cf.* Richard Eckman, *Recent Usury Law Developments: The Delaware Consumer Credit Bank Act and Exporting Interest Under § 521 of the Depository Institutions Deregulation and Monetary Control Act of 1980*, 39 Bus. Law. 1251, 1264 (1984).

It worked, too. South Dakota's tax revenue from banks went from \$3.2 million in 1980 to almost \$27.2 million in 1987, with the comparable figures for Delaware rising from \$2.4 million to almost \$40 million. The Economist, July 2, 1988, at 26.

card debt had grown to $50 billion, up from just $5.3 billion when the Truth in Lending Act was passed.[16]

Industry executives also have recognized escalating pricing and advertising problems in the U.S. credit card market. In 2003, Duncan MacDonald, the former general counsel for Citigroup's North American and European credit card businesses, wrote about the credit card pricing mess in the American Banker.[17] Mr. MacDonald observed that the Office of the Comptroller of the Currency – the primary regulator of national banks – had "turned a blind eye to [the] lawlessness" of certain credit card issuers. Mr. MacDonald also decried "The Frankenstein" (his word) that had been created by the Supreme Court's *Smiley* decision. He noted that credit card penalty fees were becoming a "substitute for APRs," and that the industry had devolved into "trip wire pricing," in which any cardholder misstep would set off a series of booby trap rates and penalty fees. He further observed that card pricing had become a massive subsidy for the rich. The penalty fees and rates charged to less well-off cardholders -- who usually revolve their balances -- were subsidizing the cash back and frequent flyer perks used to entice the super-creditworthy, who typically do not carry monthly balances.

Credit card debt has caught millions of households in a trap they simply cannot extricate themselves from without feeling the pressure to file bankruptcy. At the same time, credit card earnings have been consistently higher than returns on all commercial

16 Diane Ellis, *The Effect of Consumer Interest Rate Deregulation on Credit Card Volumes, Charge-Offs, and in the Personal Bankruptcy Rate,* FDIC--Division of Insurance, Bank Trends, 98-05 (Mar. 1998), *available at* http://www.fdic.gov/bank/analytical/bank/bt_9805.html.

17 *Comptroller Has Duty To Clean Up Card Pricing Mess*, Letter to the Editor, Duncan A. MacDonald, American Banker, Nov. 21, 2003.

bank activities.[18] The problem is not the profits, it is simply that these profits are based on abusive practices, and resulting harm inflicted upon American households. The root of these problems is that credit card transactions in this nation are now completely unregulated – and this must change.

PROPOSED SOLUTIONS

More Disclosure Is Not the Answer

Because of the deregulation of bank credit, virtually no state regulation on creditor conduct applies to the practices of the credit card industry.[19] While there are some – very few – limits placed on the most outrageous abuses of consumers by banks by the federal banking regulators, the Truth in Lending Act ("TILA) is the primary regulatory structure applicable to the relationship between credit card issuers and their customers. The TILA was intended to be – and remains – primarily a disclosure statute. Through its enactment and enforcement, Congress intended to enable consumers to compare the costs of credit.[20] However, the TILA was never intended to stand on its own – to be the sole and primary means of regulating and limiting a powerful industry vis-à-

[18] Board of Governors of the Federal Reserve System, *The Profitability of Credit Card Operations of Depository Institutions* (June 2004), *available at* http://www.federalreserve.gov/boarddocs/rptcongress/creditcard/2004/ccprofit.pdf. While the profitability of the credit card industry as a whole has fluctuated somewhat over these years, this is largely due to the changeability of the group of banks included in the sample. *Id.* at 2.

[19] For example, when the state of California tried to address the issue of tiny minimum payments by requiring creditors to provide information to each consumer on how long it would take to pay off a sample credit card balance if only the minimum payment was paid each month, a federal district held the statute was preempted by federal banking statutes. *American Bankers Association v. Lockyer*, 239 F. Supp.2d 1000 (E.D. Cal. 2002).

[20] 15 U.S.C. § 1601(a).

vis the individual consumers who borrow money for personal, family or household purposes. Indeed, when the TILA passed in 1968, state usury and fee caps applied to credit card transactions.

Uniform and accurate disclosures *are* useful for consumers, but they cannot substitute for real regulation. The best proof of this is the unbalanced and dangerous situation that the American consumers find themselves in with the open-end credit industry today.

Disclosures are only useful for consumers when all of the following conditions exist –

- The consumer has the opportunity to read the disclosures fully;
- The disclosures are unambiguous and understandable;
- The disclosures are true and apply to the entire term of the contract;
- The consumer has the knowledge and sophistication to understand the meaning of the information provided in the disclosures;
- The consumer has the opportunity to make choices based on the information gained through the disclosures.

Moreover, disclosures alone are not sufficient to protect consumers from over-reaching creditors. This is because --

- Consumers lack equal access to information – most consumers will not have the knowledge to understand the legal consequences of the terms of credit.
- Consumers lack equal bargaining power – no consumer has the market power to call up a credit card company and negotiate either the basic terms or those in the adhesion contract.
- The credit card market does not provide real choices. With the increasing consolidation of credit card providers, the industry guarantees *less* meaningful competition. There is generally competition only on the surface, on a few prominently-advertised terms such as the periodic rate and annual fee. Consumers have little or no meaningful choices on the terms that create the bulk of the cost of open-end credit.
- Without some basic substantive regulation, there will continue to be competition between industry players only as to which can garner the most profit from the most consumers – regardless of the fairness, or the effects on consumers.

Recommendations for Statutory Reform

The credit card market in the U.S. is now very mature. To increase market share, industry participants must be more aggressive in their pricing strategies. Because the APR is the primary measure of competitiveness, back-end penalty fees will continue to increase to offset the risks in credit card marketing plans. Consumers do not, however, shop for credit cards based on their penalty fees, and no real competition will ever exist to damper the escalation of those fees. To restore real competition based on the APR, all bank penalties should be controlled by the longstanding common law rules on penalties – the fees are capped by the actual or reasonably expected cost to the bank from a cardholder's breach. This is the principles-based standard reiterated for such fees by the Office of Fair Trading in the United Kingdom and Europe, and it should be applied here as well. Without such an approach, we will continue to see a race to the bottom for backend penalties while the banks deceptively tout unrealistically low APRs.

Accordingly, it is time for the re-regulation of credit card transactions. Real, substantive limits on the terms of credit, and the cost of the credit, including the interest rate and all fees and charges, must be re-imposed. This includes:

- A cap on all periodic interest rates, for example, prime plus 10%.
- A cap on all other charges, whether considered a finance charge or not, to an amount the card issuer can show is reasonably related to cost.
- No unilateral change-in-terms allowed.
- No retroactive interest rate increases allowed.
- No penalties allowed for behavior not directly linked to the specific card account at issue.
- No over limit fees allowed if issuer permits credit limit to be exceeded.
- No improvident extensions of credit–require real underwriting of the consumer's ability to pay.
- No mandatory arbitration, either for consumers' claims, or for collection actions against consumers.

- Meaningful penalties for violating any substantive or disclosure requirement that provide real incentives to obey the rules.
- A private right of action to enforce section 5 of the Federal Trade Commission Act, which prohibits unfair or deceptive practices by businesses, including banks.

It is no longer a question of balancing the appropriate regulation with the need to assure access to credit. The increasing mountain of debt held by American consumers, coupled with the growing number of abusive practices by the credit card companies, illustrate amply de-regulation has not worked. Since biblical times government has recognized that consumers need strong, enforceable limits placed on the power of lenders to exert their far greater bargaining power in the marketplace. The age old protection of borrowers from over-reaching lenders needs to be reinstituted. We look forward to working with Chairman Conyers and other members of this committee to achieve a modicum of justice for average consumers.

BusinessWeek

COVER STORY June 5, 2008, 5:00PM EST

Banks vs. Consumers (Guess Who Wins)

The business of resolving credit-card disputes is booming. But critics say the dominant firm favors creditors that are trying to collect from unsophisticated debtors

by Robert Berner and Brian Grow

What if a judge solicited cases from big corporations by offering them a business-friendly venue in which to pursue consumers who are behind on their bills? What if the judge tried to make this pitch more appealing by teaming up with the corporations' outside lawyers? And what if the same corporations helped pay the judge's salary?

It would, of course, amount to a conflict of interest and cast doubt on the fairness of proceedings before the judge.

Yet that's essentially how one of the country's largest private arbitration firms operates. The National Arbitration Forum (NAF), a for-profit company based in Minneapolis, specializes in resolving claims by banks, credit-card companies, and major retailers that contend consumers owe them money. Often without knowing it, individuals agree in the fine print of their credit-card applications to arbitrate any disputes over bills rather than have the cases go to court. What consumers also don't know is that NAF, which dominates credit-card arbitration, operates a system in which it is exceedingly difficult for individuals to prevail.

Some current and former NAF arbitrators say they make decisions in haste—sometimes in just a few minutes—based on scant information and rarely with debtor participation. Consumers who have been through the process complain that NAF spews baffling paperwork and fails to provide the hearings that it promises. Corporations seldom lose. In California, the one state where arbitration results are made public, creditors win 99.8% of the time in NAF cases that are decided by arbitrators on the merits, according to a lawsuit filed by the San Francisco city attorney against NAF.

"NAF is nothing more than an arm of the collection industry hiding behind a veneer of impartiality," says Richard Neely, a former justice of the West Virginia supreme court who as part of his private practice arbitrated several cases for NAF in 2004 and 2005.

A DIFFERENT REALITY

NAF presents its service in print and online advertising as quicker and less expensive than litigation but every bit as unbiased. Its Web site promotes "a fair, efficient, and effective system for the resolution of commercial and civil disputes in America and worldwide."

But internal NAF documents and interviews with people familiar with the firm reveal a different reality. Behind closed doors, NAF sells itself to lenders as an effective tool for collecting debts. The point of these pitches is to persuade the companies to use the firm to resolve clashes over delinquent accounts. JPMorgan Chase (JPM) and Bank of America (BAC) are among the large institutions that do so. A September, 2007, NAF PowerPoint presentation aimed at creditors and labeled "confidential" promises "marked increase in recovery rates over existing collection methods." At times, NAF does this kind of marketing with the aid of law firms representing the very creditors it's trying to sign up as clients.

NAF, which is privately held, employs about 1,700 freelance arbitrators—mostly moonlighting lawyers and retired judges—who handle some 200,000 cases a year, most of them concerning consumer debt. Millions of credit-card accounts mandate the use of arbitration by NAF or one of its rivals. NAF also resolves disputes involving Internet domain names, auto insurance, and other matters. In 2006 it had net income of $10 million, a robust margin of 26% on revenue of $39 million, according to company documents.

NAF's success is part of a broader boom in arbitration dating back to the 1980s, when companies began introducing language into employment contracts requiring that disputes with workers be resolved out of court. Mandatory arbitration spread to other kinds of agreements, including those involving credit cards.

NUMEROUS LOYAL PATRONS

Now, with the economy stumbling, NAF's focus on consumer credit could prove even more lucrative. U.S. credit-card debt hit a record high of $957 billion in the first quarter of 2008, up 8% from the previous year, according to Federal Reserve data. People who had relied on home-equity loans are seeing that money evaporate in the mortgage crisis and are running up card balances. Card providers, meanwhile, are increasingly turning to arbitration to collect on delinquent accounts.

Even consumer advocates concede that most people accused of falling behind do owe money. But the amounts are often in dispute because of shifting interest rates, fees, and penalties. Sometimes billing mistakes or identity fraud lead to confusion. Plenty of acrimony surrounds the traditional collections process in which lenders' representatives or companies that buy debt at a discount pressure consumers to pay up. Arbitration is supposed to be different. Endorsed by federal law, it purports to offer something akin to the evenhanded justice of the court system. That's why state and federal judges overwhelmingly uphold arbitration awards challenged in their courtrooms. This confidence may be misplaced, however, at least in many cases that come before NAF. (Its main competitors—the nonprofit American Arbitration Assn. in New York and JAMS, a for-profit firm in Irvine, Calif.—tend to attract employment disputes and contractual fights between companies.)

NAF has numerous loyal patrons among the country's financial titans. Chase says in a statement that it "uses NAF almost exclusively in its collection-arbitration proceedings due to NAF's lower cost structure." Companies pay from $50 to several hundred dollars a case, depending on its complexity. "Many legal commentators have found arbitration to be fair, efficient, more consumer friendly, and faster than the court system," Chase adds. Roger Haydock, NAF's managing director, says: "This is like the *Field of Dreams*: Build a ballpark, and they will come."

Others argue that NAF umpires make calls that put debtors at a disadvantage. In March, Dennis J. Herrera, San Francisco's city attorney, sued the firm in California state court, accusing it of churning out awards for creditors without sufficient justification. The lawsuit cites state records showing that NAF handled 33,933 collection arbitrations in California from January, 2003, through March, 2007. Of the 18,075 that weren't dropped by creditors, otherwise dismissed, or settled, consumers won just 30, or 0.2%, the suit alleges. "NAF has done an end run around the law to strip consumers of their right to a fair collection process," Herrera says in an interview.

The firm counters in court papers that federal law intended to encourage arbitration precludes the suit. NAF's "neutral decision-makers constitute a system that satisfies or exceeds objective standards of fairness," the firm says in a press release. NAF adds in an e-mail that the suit obscures thousands of cases in which consumers prevail because creditors abandon their claims or the disputes are "otherwise terminated."

So far, the San Francisco litigation relies mostly on publicly available information about NAF. Internal documents and interviews provide a more detailed picture of the firm.

The September, 2007, marketing presentation, which NAF left with a prospective customer, boasts that creditors may request procedural maneuvers that can tilt arbitration in their favor. "Stays and dismissals of action requests available without fee when requested by Claimant—allows Claimant to control process and timeline," the talking points state.

A current NAF arbitrator speaking on condition of anonymity explains that the presentation reflects the firm's effort to attract companies, or "claimants," by pointing out that they can use delays and dismissals to manipulate arbitration cases. "It allows the [creditor] to file an action even if they are not prepared," the arbitrator says. "There doesn't have to be much due diligence put into the complaint. If there is no response [from the debtor], you're golden. If you get a problematic [debtor], then you can request a stay or dismissal." When some creditors fear an arbitrator isn't sympathetic, they drop the case and refile it, hoping to get one they like better, the arbitrator says.

The firm goes out of its way to tell creditors they probably won't have to tussle with debtors in arbitration. The September, 2007, NAF presentation informs companies that in cases in which an award or order is granted, 93.7% are decided without consumers ever responding. Only 0.3% of consumers ask for a hearing; 6% participate by mail.

NAF says in a statement that it legitimately markets its services. As for the evenhandedness of the process, it adds: "Arbitration procedures are quite flexible and make stays and adjournments available to both claimants and respondents."

Many arbitrators praise NAF. In response to *BusinessWeek*'s (MHP) inquiries, the firm sent an e-mail to a group of arbitrators asking for statements "demonstrating that you provide an invaluable service to the public by acting as a fair, independent, and unbiased Neutral." NAF passed along 10 testimonials. In one, Michael Doland, an arbitrator and attorney in Los Angeles, says: "The cynical view that arbitrators favor businesses over consumers is not correct with regards to the NAF. No communication, direct or indirect, from the NAF to myself as an arbitrator ever suggested such an approach." In an interview, Doland says: "If I ever thought this process was corrupt, that would be the day, the hour, that I would resign."

But other arbitrators have quit NAF for just that reason. Elizabeth Bartholet, a Harvard Law School professor and advocate for the poor, worked as an NAF arbitrator in 2003 and 2004 but resigned after handling 24 cases. NAF ran "an unfair, biased process," she said in a deposition in September, 2006, in an Illinois state court lawsuit. NAF isn't named as a defendant in the pending case, which challenges a computer maker's use of an NAF arbitration clause. Bartholet said that after she awarded a consumer $48,000 in damages in a collections case, the firm removed her from 11 other cases. "NAF ran a process that systematically serviced the interests of credit-card companies," she says in an interview.

In response, the firm says that both sides in each case have the right to object to one arbitrator suggested by NAF, based on the arbitrator's professional biography, which is provided to the parties. Creditors had simply exercised that option with the Harvard professor, NAF says.

SWIFT DECISIONS

Even arbitrators who speak highly of NAF say that the decision-making process often takes very little time. Anita Shapiro, a former Los Angeles superior court judge, says she has handled thousands of cases for the company over the past seven years. Creditors' lawyers have always assured her that consumers are informed by mail when they are targeted in arbitration, as NAF rules require, she says. But in the majority of cases consumers don't respond. She assumes this is the consumers' choice. Shapiro says she usually takes only "four to five minutes per arbitration" and completes "10 to 12 an hour." She is paid $300 an hour by NAF. If she worked more slowly, she suspects the company would assign her fewer cases.

Asked about Shapiro's account, NAF says: "Arbiters alone determine the amount of time required to make their decisions." It adds that collections cases tried in court are often decided swiftly when consumers don't respond. NAF says its "arbitrators provide much greater access to justice for nonappearing consumer parties by ensuring that the [corporate] claimant submits sufficient evidence."

But some consumers, including those on whose behalf the city of San Francisco is suing, complain that they don't have a real opportunity to contest NAF arbitration cases. By design, arbitration rules are less formal than those of lawsuits. The target of an arbitration can be informed by mail rather than being served papers in person. Evidence can be introduced without authentication.

In March the law firm Wolpoff & Abramson settled a class action in federal court in Richmond, Va., alleging unfairness by the firm in NAF arbitrations. The suit, filed on behalf of 1,400 Virginia residents pursued by the credit-card giant MBNA, claimed that Wolpoff & Abramson, which represented the company, promised them in writing that they could appear at hearings before an NAF arbitrator but then failed to arrange for the hearings. NAF wasn't named as a defendant in the suit. Denying wrongdoing, Wolpoff & Abramson agreed to pay a total of $60,000 in damages. The firm, based in Rockville, Md., declines to comment. NAF denies that consumers were falsely promised hearings.

TROUBLING FORMS

Diane McIntyre, a 52-year-old legal assistant and one of two lead plaintiffs in the Virginia class action, says she was gradually paying down $9,000 she owed MBNA. She had reduced her debt to about $6,000 when she got word in May, 2005, from Wolpoff & Abramson of an arbitration award against her for $6,519, plus $977 in legal fees. She intended to contest the amount of the award and the fees at a hearing but never had a chance. "I wanted to pay the debt" but not all at once, she explains. As part of the class action settlement, Wolpoff & Abramson agreed to accept $4,000 from McIntyre.

A number of other NAF arbitrators*BusinessWeek* contacted independently say that even apart from the absence of debtors contesting most cases, NAF's procedures tend to favor creditors. What most troubled Neely, the former West Virginia supreme court justice, was that NAF provided him with an award form with the amount sought by the creditor already filled in. This encourages the arbitrator to "give creditors everything they wanted without having to think about it," says Neely.

In the three NAF cases he decided, Neely says he granted the credit-card companies the balances and interest they claimed but denied them administrative fees, which totaled about $300 per case. Neely says such fees wouldn't be available to creditors who filed suit in court. "It's a system set up to squeeze small sums of money out of desperately poor people," he asserts. Neely stopped receiving NAF assignments in 2006 after he published an article in a legal publication accusing the firm of favoring creditors.

NAF says that Neely's accusations lack "any shred of truth." The independence of its arbitrators ensures they will decide cases diligently, NAF adds. "Arbitrators are in no way discouraged from deviating from the [creditor's] requested relief."

Lewis Maltby, a lawyer in Princeton, N.J., decided six credit-card cases for NAF in 2005 and 2006 but says he stopped because, like Neely, he became "uncomfortable" with the process. Maltby runs a nonprofit group promoting employee rights and has served as a director of the American Arbitration Assn. (AAA). Working for NAF, he was surprised at how little information he received to make his decisions. Files contained printouts purporting to summarize a consumer's debt and an unsigned, generic arbitration agreement, he says. "If you wanted free money, you could do [each case] in five minutes."

Maltby says the most difficult cases to decide were three claims by MBNA to which consumers did not respond. The files lacked any evidence that the consumer had been notified, he says. He ruled in MBNA's favor, having assumed that the debts were "probably" genuine. But he adds: "I would have liked to have been more confident that was the case." He did slice the fees requested by creditors' lawyers, because he thought they had expended little effort. He decided one other case for MBNA after the debtor conceded in writing that he owed money but couldn't afford to pay. MBNA withdrew another claim after the consumer said he had been the victim of identity theft, Maltby says.

In a statement, NAF says that *BusinessWeek* misrepresented Maltby's views. But Maltby later said he stands by all his comments. In a statement, Bank of America, which acquired MBNA in January, 2006, declines to comment because of the suit filed by San Francisco against NAF.

William A. Gould Jr., a Sacramento lawyer with a general private practice, says he stopped handling arbitrations for the company after doing several in 2003 and 2004 because the process "just seemed to be pretty one-sided." He says he didn't observe specific instances of bias but became concerned about the imbalance between creditors and their law firms—which were highly sophisticated about NAF procedures—and most consumers, who were naive and lacked legal representation. "The whole organizational mechanism was set up to effect collections," Gould says. Asked to respond, NAF says creditors and their attorneys are "no more sophisticated" about arbitration than they are about court procedures, and consumers are "no more naive."

Founded in 1986, NAF at first depended heavily on one customer, ITT Consumer Financial, the now-defunct lending arm of conglomerate ITT. (ITT) Milton Schober, then the general counsel of ITT Consumer Financial, says he opposed the relationship, fearing it could deny individuals the broader rights they enjoyed in court, such as greater latitude to appeal. Top officials of ITT Consumer Financial, which like NAF was based in Minneapolis, felt otherwise. "Management thought [NAF's] rules for arbitration favored creditors more," says Schober, who is now retired. "Shopping for justice: That's what it was." Neither NAF nor ITT, now a defense electronics manufacturer, would comment on Schober's assertions.

BUSINESS STRATEGY

Haydock, NAF's managing director, says that from the outset, it tried to familiarize corporations and their attorneys with the benefits of arbitration over court cases. NAF isn't alone in doing this. AAA and JAMS also place ads in legal publications and sponsor events at bar association meetings.

But NAF goes further. On some occasions, it tries to drum up business with the aid of law firms that represent creditors. Summaries of weekly NAF business development meetings from 2004 and 2005, which are labeled "confidential," show it enlisted Wolpoff & Abramson and another prominent debt collection law firm, Mann Bracken, to help win the business of companies such as GE's (GE) credit-card arm. When creditors succeed, the law firms seek fees of 15% or 20% of awards, which are added to judgments and billed to debtors. Atlanta-based Mann Bracken surfaces in a November, 2004, NAF document that states: "Work with Mann to begin its taking lead on GE as it relates to Mann running the program for it."

The same NAF document describes efforts to collaborate with Mann Bracken and Wolpoff & Abramson to recruit Sherman Financial Group as an arbitration customer. Sherman, based in Charleston, S.C., buys delinquent debt from major credit-card companies at a discount and then tries to collect on it. Under the heading "Last Week's Single Sales Objective," the NAF document notes that Wolpoff & Abramson and Mann Bracken partner James D. Branton are to host a panel discussion with attorneys for Sherman Financial. "Follow-up w/ Branton and Wolpoff after conference," the document adds.

The strategy appears to have worked. Sherman confirms that Mann Bracken has represented it in collections cases before NAF. But Sherman denies that either law firm solicited its business on behalf of the arbitration firm.

A former NAF staff employee familiar with its business development efforts says: "It was well understood within NAF that working through established collection law firms was an effective way to develop business with creditors." Insisting on anonymity, the ex-employee explains that, since Wolpoff & Abramson and Mann Bracken had strong ties to major credit- card companies, the law firms could boost NAF's chances of getting creditors to use its services. All told, documents from four NAF business development meetings from October, 2004, through August, 2005, refer 36 times to Wolpoff & Abramson, Mann Bracken, and their attorneys in connection with pitches to credit-card providers and debt buyers.

An arbitration company collaborating with law firms to land business troubles some legal scholars. "Most people would be shocked," says Jean Sternlight, an arbitration expert at the University of Nevada, Las Vegas. "Our adversarial system has this idea built into it that the judge is supposed to be neutral, and NAF claims that it is," she adds. "But this certainly creates a great appearance, at a minimum, of impropriety, where the purportedly neutral entity is working closely with one of the adversaries to develop its business."

"STREAMLINING" THE PROCESS

Mann Bracken's Branton declines to discuss specific clients, citing confidentiality agreements. In an e-mail, he adds: "Mann Bracken frequently and openly works with arbitration administrators (including the National Arbitration Forum and the American Arbitration Assn.) to assist our clients in developing legal solutions tailored to their needs. This is very similar to the work we do with court clerks across the country in streamlining the litigation process for our clients."

NAF's rivals, AAA and JAMS, say they don't cooperate with debt collection law firms in this manner. "Those who inquire about filing cases with us, which include individuals, governmental entities, and businesses, often reach out to understand how to use our online filing process, which is available to all parties," says AAA spokesman Wayne Kessler. The firm says it handled 8,358 consumer arbitration cases in 2007, far fewer than NAF. JAMS says it doesn't handle such cases.

NAF arbitrators say they aren't familiar with all the ways the company markets itself. When told about the internal documents, however, several expressed concern. "Using a law firm to actually solicit business for [NAF] raises a question of the appearance, at least, of potential impropriety," says Edwin S. Kahn, a lawyer in Denver who advocates for low-income families and, as a sideline, has handled about 30 NAF cases and 50 AAA cases. Kahn says he is considering recusing himself from cases involving Mann Bracken and Wolpoff & Abramson: "I have learned something that might affect my objectivity."

NAF interprets Kahn's comments as showing that "he is very aware of his professional responsibility to remain entirely neutral." It adds that it has "been successful in completely isolating the independent arbitrators from educational and marketing efforts used to encourage the use of arbitration."

Edward C. Anderson, an NAF founder and past CEO, confirms that the company does "educate" creditors' lawyers on the benefits of arbitration in hopes that the lawyers' clients will purchase NAF's services. He sees no conflict of interest. "The documents that you have apparently relate to meetings with particular lawyers," he says. "It looks to me like we pitched these lawyers on the efficacy of arbitration for their clients, and they have to decide what works for them." Mann Bracken and Wolpoff & Abramson decline to comment.

GE confirms that it employs Mann Bracken and says consumers may resolve disputes before NAF or AAA. Consumers also may opt out of GE's arbitration clause, although relatively few do. In a statement, GE spokeswoman Cristy F. Williams says that when the company initiates collection actions, "it has historically always filed in a court of appropriate jurisdiction." She adds that GE's arbitration clause referring to NAF was in place before the 2004 and 2005 references to Mann Bracken in the NAF documents. GE declines to respond to questions about the overall fairness of NAF arbitration or on Mann Bracken's role in aiding NAF to gain arbitration business.

EASING THE COURT'S LOAD

Most judges are favorably disposed toward arbitration as a way of alleviating the courts' litigation load. In one case in which customers questioned the use of an arbitration clause by credit-card issuer First USA Bank, a federal judge in Dallas ruled in 2000: "The court is satisfied that NAF will provide a reasonable, fair, impartial forum."

But some courts have found reason to question NAF awards. In May, 2005, a state judge in Oregon threw out a $16,642 arbitration judgment favoring MBNA. Judge Donald B. Bowerman didn't explain his reasoning, but the consumer in the case, Laurie A. Raymond, had appealed the award, saying she had been complaining to MBNA since 1990 that the charges attributed to her were the result of fraud or a mistake. Raymond, a 54-year-old family-law attorney in Portland, also told the court that she had never signed an arbitration agreement. Unlike most alleged debtors, Raymond energetically disputed NAF's jurisdiction. The credit-card company at certain points in the past had conceded that she didn't have to pay, she says. Nevertheless, in July, 2004, the arbitrator entered the award for the bank without holding the hearing Raymond says she had requested.

After Raymond got the award canceled, she sued MBNA for violations of debt collection and credit reporting laws. MBNA settled the suit on confidential terms. MBNA parent Bank of America declines to comment specifically, citing privacy obligations. "The referral to arbitration was consistent with the practices in place at the time," the bank says. "We believe arbitration can be an efficient and fair method of resolving disputes between our customers and the company."

NAF declines to comment on the Raymond case. But generally, the company adds: "Litigants, on either side, do not always see the facts, the law, or the process through an unbiased eye."

Raymond felt equipped to take on NAF and MBNA because of her legal training, she says. "One reason I went on with the process was that if [NAF] can do this to someone who understands this stuff, what are they doing to the little grandma next door?"

Cheryl C. Betts of Cary, N.C., was one layperson who felt overwhelmed. She learned that she'd been taken to arbitration in May, 2007, when Mann Bracken sent her a letter about $6,027 she owed on a Chase credit card. The letter informed her that she'd have to pay an additional $602 in legal fees related to arbitration but offered to settle for 75% of the total, or $4,972. Betts, a 55-year-old former administrative assistant for an energy company, says she always intended to pay her debt but didn't want to cough up nearly $5,000 at once. "I'm not a deadbeat," she says.

Betts says her troubles began after she was late with one $128 minimum payment in August, 2005. Chase lowered her credit limit from $6,000 to $4,900. Fees and penalty interest soon pushed her over that limit, setting off a spiral of rising minimum- payment demands that she says she couldn't afford. Betts says she repeatedly contacted the bank to try to work out a payment plan. "This should never have happened," she says.

Chase declines to comment on particular credit disputes, citing customer privacy. The bank points to a 2000 opinion by U.S. Supreme Court Justice Ruth Bader Ginsburg saying that "national arbitration organizations have developed similar models for fair cost and fee allocation.... They include National Arbitration Forum provisions that limit small-claims consumer costs."

The May, 2007, letter to Betts from Mann Bracken announcing its intention to arbitrate set off a nine-month flurry of paperwork. In August, after she filed an 11-page response to the arbitration claim, Mann Bracken requested an adjournment, which was granted. Four months later, Betts fired off a long fax further disputing the case, and the law firm responded by seeking a 45-day extension. Betts thought she would have another opportunity to contest the case.

But on Feb. 15, 2008, the day after the extension expired, an NAF arbitrator issued a ruling ordering her to pay $5,575 to Chase. She has taken the case to a state court in Raleigh. "Many people," she says, "would have thrown in the towel because they don't have the time to pursue this, or they are just totally confused.... The only thing that kept me going was that I knew that I hadn't done anything wrong."

NAF declines to comment on the Betts case but reiterates that its procedures are fair. It adds that "parties can become confused about court procedures or about arbitration procedures.... "

Join a debate about regulating credit card rates.

Berner is a correspondent for BusinessWeek in Chicago. Grow is a correspondent in BusinessWeek's Atlanta bureau.

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IN THE COURT OF APPEAL OF THE STATE OF CALIFORNIA

FIRST APPELLATE DISTRICT

DIVISION 1

ANASTASIYA KOMAROVA,	)	
	)	
Plaintiff/Respondent,	)	
	)	Case No.: A121316
v.	)	
	)	San Francisco County Superior
NATIONAL CREDIT	)	Court Case No.: 456891
ACCEPTANCE, INC.,	)	
	)	
Defendant/Appellant	)	

Appeal from the Superior Court of the State of California
County of San Francisco
The Honorable Ernest Goldsmith

BRIEF OF *AMICI CURIAE* PUBLIC JUSTICE AND THE NATIONAL CONSUMER LAW CENTER IN SUPPORT OF RESPONDENT ANASTASIYA KOMAROVA

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INTERESTS OF *AMICI CURIAE*

Public Justice, P.C., is a national public interest law firm dedicated to fighting for justice through precedent-setting and socially significant individual and class action litigation designed to enhance consumer and victims' rights, environmental protection and safety, civil rights and civil liberties, workers' rights, America's civil justice system, and the protectiou of the poor and powerless. Public Justice is committed to ensuring that all Americans have meaningful access to justice in their dealings with large corporations. Public Justice has particular interest in this case because of its longstanding concern about debt collectors' increasing use of arbitration proceedings before the National Arbitration Forum (NAF) to collect consumer debts.

The National Consumer Law Center is a Massachusetts non-profit corporation established in 1969 and incorporated in 1971. It is a national research and advocacy organization focusing specifically on the legal needs of low income, financially distressed, and elderly consumers.

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INTRODUCTION

This case involves a question of tremendous importance to California consumers: whether debt collectors are granted immunity from liability for violations of California's Rosenthal Fair Debt Collection Practices Act (Rosenthal Act), Civil Code § 1788 *et seq.*, by the litigation privilege. A jury found that the debt collector in this case, National Credit Acceptance (NCA), had violated the Rosenthal Act by repeatedly calling Plaintiff/Respondent Anastasyia Komarova at work, for a full year, and threatening her and her husband's savings. NCA argues that it should nevertheless be immune from the Rosenthal Act because its abusive debt-collection practices were related to a "quasi-judicial" proceeding before the National Arbitration Forum (NAF). *See* Appellant's Br. 17. But the litigation privilege, to the extent that it applies to arbitrations, does so only because of arbitration's "analogy to a judicial proceeding." *Moore v. Conliffe*, 7 Cal. 4th 634, 647 (1994) (citing *Ribas v. Clark*, 38 Cal. 3d 355, 364 (1985)). The true nature of NAF's practices and proceedings, as demonstrated by a number of media reports, studies, and court cases, makes clear that NAF consumer arbitrations lack many of the basic characteristics and safeguards of judicial proceeds. As such, permitting this immunity would eviscerate the Rosenthal Act and have disastrous consequences for consumers.

ARGUMENT

I. THE ROSENTHAL ACT IS INTENDED TO DETER ABUSES BY DEBT COLLECTORS

Debt collection is a hugely profitable business—indeed, it is one of the few "bright spots" in today's troubled economy. Phyllis Korkki, *The Count*, N.Y. Times, Nov. 30, 2008. According to one study, revenue from debt collection, which reached almost $14.3 billion in 2008, is expected to rise to nearly $17.8 billion in 2014. *Id.*

Despite state and federal laws designed to prevent abuses by debt collectors, the industry continues to engage in abusive practices. The Federal Trade Commission (FTC) "receives more complaints about the debt collection industry than any other specific industry." Federal Trade Commission, *Annual Report 2008: Fair Debt Collection Practices Act* 4, *available at* http://www.ftc.gov/os/2008/03/P084802fdcpareport.pdf. In 2007, the most recent year for which data are available, consumer complaints to the FTC about third-party debt collectors increased from 19.9% of all FTC complaints in 2006 to 20.8% of complaints.

More than thirty years ago, the California Legislature recognized that abusive debt collection practices "undermine the public confidence which is essential to the continued functioning of the banking and credit system." Civ. Code § 1788.1(a). As a result, in 1977 it enacted the Rosenthal Act for the purpose of "prohibit[ing] debt collectors from engaging in unfair or deceptive acts or practices in the collection of consumer debts and to require debtors to act fairly in entering into and honoring such debts." § 1788.1(b). Today, the Rosenthal Act stands as crucial protection for consumers against "the pernicious effect of debt collection practices." *Butler v. Resurgence Fin., LLC*, 521 F. Supp. 2d 1093, 1096 (C.D. Cal. 2007).

The Rosenthal Act was thus intended to protect consumers from abuses by debt collectors. Nevertheless, in this case, NCA is attempting to conjure a legal barrier to the application of the Rosenthal Act that, if the Court accepts it, would have catastrophic consequences for California consumers. Under NCA's theory of the litigation privilege, debt collectors would be utterly immune from the proscriptions of the Rosenthal Act simply by choosing to collect their debt by means of an arbitration procedure. Given the frequency with which debt collectors turn to NAF to effect consumer debt collections,[1] this interpretation of the privilege "would effectively vitiate the Rosenthal Act and render the protections it affords meaningless." *Oei v. N. Star Capital Acquisitions, LLC*, 486 F. Supp. 2d 1089, 1101 (C.D. Cal. 2006). *See also Yates v. Allied Int'l Credit Corp.*, 578 F. Supp. 2d 1251, 1255 (S.D. Cal. 2008) ("[T]his Court will not allow the litigation privilege to defeat the protections of the Rosenthal Act."); *Butler*, 521 F. Supp. 2d at 1096-97 ("If the litigation privilege were allowed to swallow the protections of the Rosenthal Act, the Legislature's purpose could not be effectuated. Therefore, in light of these considerations, we conclude that the litigation privilege does not apply to the provisions of the Rosenthal Act."). It amounts to a dramatic reinterpretation of California law that flies in the face of the intent of the legislature as well as the reality that, especially in the current economy, consumers desperately need protection from abusive debt collection practices.

NCA's radical interpretation of the litigation privilege is particularly alarming in light of the true nature of NAF arbitration, through which NCA

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[1] Between January 1, 2003, and March 31, 2007, NAF handled more than thirty thousand collection cases in California alone, Public Citizen, *The Arbitration Trap: How Credit Card Companies Ensnare Consumers* 5-6 (2007), http://www.citizen.org/documents/ArbitrationTrap.pdf, including two thousand brought by NCA. *See* Public Citizen, NAF California data (2007), *available at* http://www.citizen.org/congress/civjus/arbitration/NAFCalifornia.xls.

endeavored to collect its purported debt in this case. As the following section will demonstrate, NAF arbitrations amount to a mere rubber-stamp of a debt collector's request for an award. These arbitrations therefore must not be permitted to be transmuted, via the litigation privilege, into a shield against the application of the Rosenthal Act to abusive debt-collection practices.

II. NAF OPERATES AS A RUBBER STAMP FOR DEBT COLLECTORS

A. NAF'S FINANCIAL INTERESTS ARE CLOSELY ALIGNED WITH THOSE OF DEBT COLLECTORS

The relationship between NAF and debt collectors begins with the credit card contract: credit card companies draft the contract, which includes a clause requiring consumers to arbitrate their disputes—usually before a specific arbitration provider—rather than sue in court. Most credit-card issuers include these mandatory arbitration clauses in their contracts. *See* Consumers Union, *Best and Worst Credit Cards*, Consumer Reports, Oct. 2007. *See also* Day to Day, *Marketplace Report: Credit Disputes Favor Companies* (NPR radio broadcast Sept. 28, 2007) (available at 2007 WLNR 19048094) ("[I]t's often hard to find a credit card that doesn't make arbitration mandatory."); Simone Baribeau, *Consumer Advocates Slam Credit-Card Arbitration*, Christian Sci. Monitor, July 16, 2007 ("[I]f you own a credit card, chances are you have a mandatory arbitration clause.").

NAF, far more so than the two other major players in the arbitration industry, the American Arbitration Association (AAA) and JAMS, has financial interests strongly aligned with credit card companies and debt collectors. Because of this association, CNN's personal finance editor called NAF "the folks who are the worst actors in this industry." Am. Morning (CNN television broadcast June 6, 2008) (transcript available at http://transcripts.cnn.com/TRANSCRIPTS/0806/06/ltm.03.html). The Wall Street Journal observed that, more than other arbitration providers, NAF works with a handful of large companies, and a "significant percentage of its work includes disputes involving consumers, rather than disputes between businesses." Nathan Koppel, *Arbitration Firm Faces Questions Over Neutrality*, Wall St. J., Apr. 21, 2008. In contrast, AAA and JAMS "tend to attract employment disputes and contractual fights between companies." Robert Berner & Brian Grow, *Banks v. Consumers (Guess Who Wins)*, BusinessWeek, June 5, 2008.

As a result of NAF's focus on consumer debt, NAF receives "considerable fees" from its creditor and debt collector clients.[2] Consumers Union, *Consumer Rights: Give Up Your Right to Sue?* Consumer Reports, May 2000. For example, First USA Bank disclosed in court filings that it had paid NAF at least $5 million in fees between 1998 and 2000. *Id.* During that same period, First USA won 99.6% of its 50,000 collection cases before NAF. *Id.* While advocates for banks invoke the possibility that the bank could have been equally successful in court, "[m]aybe, however, the millions of dollars it paid the NAF in fees tend to produce overwhelmingly favorable results." Joseph Garrison, *Is ADR Becoming "A License to Steal"?* Conn. L. Trib., Aug. 26, 2002, at 4. In sharp contrast, it would be shocking for a public court to be so financially dependent on a litigant appearing before it.

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[2] NAF arbitrations are lucrative for individual arbitrators as well as for the organization itself. One former NAF arbitrator noted, "I could sit on my back porch and do six or seven of these cases a week and make $150 a pop without raising a sweat, and that would be a very substantial supplement to my income. . . . I'd give the [credit-card companies] everything they wanted and more just to keep the business coming." Chris Serres, *Arbitrary Concern: Is the National Arbitration Forum a Fair and Impartial Arbiter of Dispute Resolutions?* Star Trib. (Minneapolis), May 11, 2008, at 1D.

There is significant evidence that NAF has a symbiotic financial relationship with these companies. As part of this relationship, NAF has aggressively marketed itself to debt collectors. Additionally, NAF's procedures for the selection and retention of arbitrators rewards arbitrators who rule in favor of business and punishes those who rule for consumers. Given the cumulative evidence about NAF's relationship with credit card companies and debt collectors, it is not surprising that NAF is subject to mounting allegations of anti-consumer bias.

B. NAF'S MARKETING MATERIALS PROMISE CREDIT CARD COMPANIES AND DEBT COLLECTORS THAT COLLECTING DEBTS THROUGH NAF ARBITRATIONS WILL SAVE THEM MONEY

Among America's major arbitration providers, NAF also has the dubious distinction of most aggressively marketing itself to credit card companies and debt collectors. *See* Caroline E. Mayer, *Win Some, Lose Rarely? Arbitration Forum's Rulings Called One-Sided*, Wash. Post, Mar. 1, 2000, at E1 ("[A]rbitration industry experts say [that] the forum's business involves more corporate-consumer disputes, in large part because of the company's aggressive marketing."). *Cf.* Michael Geist, *Fair.com? An Examination of the Allegations of Systemic Unfairness in the ICANN*

UDRP, 27 Brook. J. Int'l L. 903, 907 (2002) (in analysis of domain-name arbitration providers, noting that "[m]arketing techniques clearly illustrate one area of differentiation between providers, with the NAF adopting a far more aggressive approach than the other providers in the marketing of its services"). While NAF trumpets itself to the public as fair and neutral, "[b]ehind closed doors, NAF sells itself to lenders as an effective tool for collecting debts." Berner & Grow, *Banks v. Consumers (Guess Who Wins)*, BusinessWeek, *supra*, June 5, 2008. *See also* Sean Reilly, *Supreme Court Looks at Arbitration in Alabama Case This Week*, Mobile Reg., Oct. 1, 2000, at A1 ("In marketing letters to potential business clients, [NAF's] executives have touted arbitration as a way of eliminating class action lawsuits, where thousands of small claims may be combined."); Ken Ward, Jr., *State Court Urged to Toss One-Sided Loan Arbitration*, Charleston Gazette & Daily Mail, Apr. 4, 2002, at 5A ("[I]n solicitations and advertisements, NAF has overtly suggested to lenders that NAF arbitration will provide them with a favorable result."); Sarah Ovaska, *3 Cases Cite Payday Lending: Consumer Groups Say Arbitration Clauses Deny People Recourse to Courts*, News & Observer, Jan. 7, 2007 ("[NAF], which in 2006 resolved $3 billion worth of claims involving debts and other disputes, has been singled out by consumer advocates, who criticize it for advertising its services to businesses.").

BusinessWeek revealed one of the most shocking examples of NAF marketing to debt collectors when it described a September, 2007, PowerPoint presentation aimed at creditors—and labeled "confidential"—that promises "marked increase in recovery rates over existing collection methods." Berner & Grow, *Banks v. Consumers (Guess Who Wins)*, BusinessWeek, *supra*, June 5, 2008. The presentation also "boasts that creditors may request procedural maneuvers that can tilt arbitration in their favor. 'Stays and dismissals of action requests available without fee when requested by Claimant—allows claimant to control process and timeline.'" *Id.* Speaking on condition of anonymity, an NAF arbitrator told BusinessWeek that these tactics allow creditors to file actions even if they are not prepared, in that "[i]f there is no response [from the debtor], you're golden. If you get a problematic [debtor], then you can request a stay or dismissal." *Id.* BusinessWeek also highlighted another disturbing NAF marketing tactic: NAF "tries to drum up business with the aid of law firms that represent creditors." *Id.* Neither AAA nor JAMS cooperate with debt-collection law firms in such a manner. *Id.*

NAF has an arsenal of other ways of letting potential clients know that NAF can immunize them against liability. In one oft-cited example, an NAF advertisement depicts NAF as "the alternative to the million-dollar lawsuit." Nadia Oehlsen, *Mandatory Arbitration on Trial*, Credit Card Mgmt., Jan. 1, 2006, at 38. Additionally, NAF sends marketing letters to potential clients in which it "tout[s] arbitration as a way of eliminating class action lawsuits, where thousands of small claims may be combined . . . . [Class actions] offer a means of punishing companies that profit by bilking large numbers of consumers out of comparatively small sums of money." Reilly, *Supreme Court Looks at Arbitration in Alabama Case This Week*, Mobile Reg., *supra*, Oct. 1, 2000, at A1. NAF's marketing letters also urge potential clients to contact NAF to see "how arbitration will make a positive impact on the bottom line" and tell corporate lawyers that "[t]here is no reason for your clients to be exposed to the costs and risks of the jury system." *See* Mayer, *Win Some, Lose Rarely? Arbitration Forum's Rulings Called One-Sided*, Wash. Post, *supra*, Mar. 1, 2000, at E01. Finally, in an interview with a magazine for in-house corporate lawyers, NAF's managing director Anderson once boasted that NAF had a "loser pays" rule requiring non-prevailing consumers to pay the corporation's attorney's fees. *See Do*

An LRA: Implement Your Own Civil Justice Reform Program NOW, Metropolitan Corp. Counsel, Aug. 2001.

Consistently with NAF's signals to creditors and debt collectors that it is on their side, in the context of NAF's business of resolving domain-name disputes, NAF issues press releases that laud its arbitrators' rulings in favor of claimants. These press releases, which feature headlines such as "Arbitrator Delivers Internet Order for Fingerhut" and "May the Registrant of magiceightball.com Keep the Domain . . . Not Likely," "do little to engender confidence in the neutrality of the NAF." Geist, *Fair.com? An Examination of the Allegations of Systemic Unfairness in the ICANN UDRP*, *supra*, 27 Brook. J. Int'l L. at 907. The other two domain-name dispute arbitration providers do not issue such press releases. *Id.*

C. NAF FUNNELS ARBITRATIONS TO CORPORATE-FRIENDLY ARBITRATORS AND SHUNS CONSUMER-FRIENDLY ARBITRATORS

NAF has structured a system that both steers a startling percentage of its arbitrations to a handful of arbitrators who reliably rule in favor of businesses and shuts out arbitrators who have the gall to rule for consumers. Both of these methods of staffing arbitrations serve to enhance NAF's reputation as a business-friendly venue.

First, data provided by the NAF pursuant to California Code of Civil Procedure § 1281.96, which requires arbitration providers to disclose certain information about their arbitrations, reveal that a tiny number of NAF arbitrators decide a disproportionate number of cases.[3] The Christian Science Monitor analyzed one year of data and found that NAF's ten most frequently used arbitrators—who were assigned by NAF to decide nearly three out of every five cases—ruled for the consumer only 1.6% of the time. In contrast, arbitrators who decided three or fewer cases during that year found in favor of the consumer 38% of the time. Baribeau, *Consumer Advocates Slam Credit-Card Arbitration*, Christian Sci. Monitor, *supra*, July 16, 2007. Likewise, a comprehensive analysis of the data by Public Citizen found that one particular arbitrator, Joseph Nardulli, handled 1,332 arbitrations and ruled for the corporate claimant 97% of the time. Public Citizen, *The Arbitration Trap: How Credit Card Companies Ensnare Consumers*, *supra*, at 17. On a single day—January 12, 2007—Nardulli signed 68 arbitration decisions, giving debt holders and debt buyers every

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[3] On its website, NAF boasts that it has a total of more than 1,500 arbitrators in all 50 states, *see* National Arbitration Forum, Locations, http://www.adrforum.com/ (mouse over "About Us" menu; select "Our Neutrals"; then click on "Locations") (last visited Jan. 30, 2009), but that statistic has little significance if the vast majority of cases are steered to a small number of persons.

cent of the nearly $1 million that they demanded. *Id.* If Nardulli worked a ten-hour day on January 12, 2007, he would have averaged one decision every 8.8 minutes. An additional 28 NAF arbitrators handled nearly 90% of consumer collection cases, and "they too decided every matter . . . in favor of business entities." Compl. ¶ 24, *People v. Nat'l Arbitration Forum, Inc.*, No. C6C-08-473569 (Cal. Super. Ct. filed Aug. 22, 2008).

Further evidence of NAF's propensity for steering arbitrations to those arbitrators who will rule in favor of its clients comes from law professor Michael Geist's study of domain-name arbitration providers. Professor Geist observed that NAF's "case allocation appears to be heavily biased toward ensuring that a majority of cases are steered toward complainant-friendly panelists. Most troubling is data which suggests that, despite claims of impartial random case allocation as well as a large roster of 131 panelists, the majority of NAF single panel cases are actually assigned to little more than a handful of panelists."[4] Geist, *Fair.com? An Examination of the Allegations of Systemic Unfairness in the ICANN UDRP*, *supra*, 27 Brook. J. Int'l L. at 912. Professor Geist went on to note

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[4] "Siugle-panel" cases are those in which the NAF controls which arbitrator decides a case, in contrast to three-member panels, where the parties have more control over arbitrator selection. Geist, *Fair.com? An Examination of the Allegations of Systemic Unfairness in the ICANN UDRP*, *supra*, 27 Brook. J. Int'l L. at 911.

that "an astonishing 53% of all NAF single panel cases . . . were decided by only six people," and the "complainant winning percentage in those cases was an astounding 94%." *Id.* Importantly, neither of the other two domain-name arbitration services had such a skewed caseload. *Id.* Like aggressive advertising to potential clients, this method of attracting business is unique to NAF.

The second component of NAF's business-friendly system of arbitrator selection is its documented blackballing of arbitrators who dared to rule in favor of consumers. Harvard law professor Elizabeth Bartholet went public with her concerns that, after she awarded a consumer $48,000 in damages, NAF removed her from 11 other cases, all of which involved the same credit card company. As Bartholet described her experience to BusinessWeek, "NAF ran a process that systematically serviced the interests of credit card companies." Berner & Grow, *Banks v. Consumers (Guess Who Wins)*, BusinessWeek, *supra*, June 5, 2008. Bartholet told the Minneapolis Star-Tribune that "[t]here's something fundamentally wrong when one side has all the information to knock off the person who has ever ruled against it, and the little guy on the other side doesn't have that information. . . .That's systemic bias." Chris Serres, *Arbitrary Concern: Is the National Arbitration Forum a Fair and Impartial Arbiter of Dispute*

Resolutions? Star Trib. (Minneapolis), May 11, 2008, at 1D. Similarly, former West Virginia Supreme Court Justice Richard Neely stopped receiving NAF assignments after he published an article accusing the firm of favoring creditors. Berner & Grow, *Banks v. Consumers (Guess Who Wins)*, BusinessWeek, *supra*, June 5, 2008. In that article, Justice Neely lamented that NAF "looks like a collection agency" that depends on "banks and other professional litigants" for its revenue; he described NAF as a "system set up to squeeze small sums of money out of desperately poor people." *Id.*

D. NAF FREQUENTLY ENTERS AWARDS AGAINST CONSUMERS UNDER TROUBLING CIRCUMSTANCES

A powerful example of NAF's bias in favor of creditors and debt collectors is its widely observed habit of proceeding with arbitrations—and entering awards against consumers—based on non-existent evidence and under dubious circumstances. For example, NAF has blithely entered awards against individuals who were documented victims of identity theft, consumers who were never properly served with a notice of arbitration, and consumers who never agreed to arbitrate their dispute. Numerous courts have taken note of the monumental flaws in NAF's procedures that permit these types of arbitrations to go forward. *See, e.g.*, *Sprague v. Household Int'l*, 473 F. Supp. 2d 966, 976 n.8 (W.D. Mo. 2005) ("The fact that NAF was willing to state that only a document review is necessary in a case involving fraud and misrepresentation is further support for Plaintiffs' allegation that NAF is biased in favor of financial institutions."); *CACV of Colo., LLC v. Corda*, No. NNHCV054016053, 2005 WL 3664087 (Conn. Super. Ct. Dec. 16, 2005) (denying debt collector's motion to confirm NAF award for lack of evidence, and noting that NAF rules provide "no procedure by which the arbitrator makes any determination of whether the defendant has received actual notice of the demand for arbitration . . . . and if the defendant does not respond in writing to the demand for arbitration, NAF simply decides the case 'on the papers.' This certainly results in a high likelihood that the outcome of the arbitration will be in the defendant's favor."); *Asset Acceptance, LLC v. Wheeler*, --- S.E.2d ----, 2009 WL 71504, at *1 (Ga. Ct. App. Jan. 13, 2009) (affirming vacatur of NAF arbitration award where consumer had not received proper notice); *MBNA Am. Bank v. Barben, N.A.*, No. 92,085, 2005 WL 1214244, at *2 (Kan. Ct. App. May 20, 2005) (affirming vacatur of arbitration award issued by NAF and noting trial court's finding that delivery date on face of NAF award was "patently . . . shown to be untrue," given that neither NAF's director of arbitration nor the alleged debtor were present on the date on which the award was purportedly delivered by the director to the debtor).

NAF's willingness to enter arbitration awards against individuals who are the victim of identity theft is perhaps the most egregious example of the extent to which NAF's practices diverge from that of a court: the briefest impartial review would reveal that awards should not be entered against these individuals. *See* Sheryl Harris, *Consumers Should Be Suspicious of Arbitration Clause*, Plain Dealer (Cleveland), Feb. 17, 2005, at C5. ("Even victims of identity theft have been wrestled into arbitration [with NAF] and held responsible for charges racked up by thieves."). The following individuals represent just a few instances of NAF's entering awards against identity theft victims.

- Six months after Beth Plowman used her MBNA card to pay a hotel bill while on a business trip to Nigeria in 2000, MBNA called her to collect more than $26,000 spent at sporting goods stores in Europe. Plowman had received no credit card statements during those six months; MBNA told her that "her sister"—Plowman has no sisters—had changed the address on the account to an address in London. Plowman filed an identity theft report with the police and heard nothing more from MBNA. But two years later, a debt collection agency that had purchased the debt from MBNA got an arbitration award against her from NAF. Eileen Ambrose, *Read the Fine Print: Arbitration Clause Can Sting You*, Fort Wayne J. Gazette, Mar. 15, 2005, at 8.

- Troy Cornock received a letter from NAF claiming that he owed money on an MBNA credit card, but he had never signed a credit card agreement or made any charges on the account, which had been opened by his ex-wife. NAF ruled against him anyway. Gary Weiss, *Credit Card Arbitration* (Oct. 11, 2007), Forbes.com, http://www.forbes.com/2007/10/10/gary-weiss-credit- oped-cx_gw_1011weiss.html. But when MBNA attempted to enforce the NAF award in court, the court granted Cornock's motion for summary judgment, stating that "in the absence of a signed credit card application or signed purchase receipts demonstrating that the defendant used and retained the benefits of the card, the defendant's name on the account, without more, is insufficient evidence that the defendant manifested assent. . . . To hold otherwise *would allow any credit card company to force victims of* *identity theft into arbitration*, simply because that person's name is on the account." *MBNA Am. Bank, N.A. v. Cornock*, No. O3-C-0018, slip. op. at 25 (N.H. Super Ct. Mar. 20, 2007) (emphasis added).

- Irene Lieber, who lives on $759 a month in Social Security disability payments, was hounded by a debt collection agency after her MBNA credit card was stolen. Lieber later received a notice of arbitration from NAF. With the help of a legal services attorney, she asked to see the case against her or for the claim to be dismissed. But Lieber heard nothing until another notice arrived, stating that NAF had issued a $46,000 award against her. Laura Rowley, *Stacking the Deck Against Consumers* (Oct. 17, 2007), Yahoo! Finance, http://finance.yahoo.com/ expert/article/moneyhappy/48748.

NAF is also notorious for failing to ensure that consumers actually agreed to arbitrate their disputes. In one such case, the Kansas Supreme Court chided MBNA for its "casual approach to this litigation." *MBNA Am. Bank, N.A. v. Credit*, 132 P.3d 898, 902 (Kan. 2006) (vacating NAF arbitration award where MBNA failed to prove alleged debtor had agreed to arbitration). That MBNA would have such a "casual approach" is not surprising in light of MBNA's usual proceedings before NAF: it was accustomed to being able to get arbitration awards from NAF arbitrators notwithstanding its failure to produce arbitration agreements. *See id.* at 899 (noting that NAF arbitrator entered award in the amount of $21,094.74 in favor of MBNA). Another example is *MBNA America Bank, N.A. v. Christanson*, 659 S.E.2d 209, 210, 213 (S.C. Ct. App. 2008), where the South Carolina Court of Appeals refused to confirm an NAF arbitration award in favor of MBNA that had been entered despite the consumer's repeated assertions that he never agreed to arbitrate.[5]

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[5] Numerous other courts have refused to confirm NAF awards for similar reasons. *See, e.g., MBNA Am. Bank, N.A. v. Boata*, 893 A.2d 479 (Conn. App. Ct. 2006) (permitting consumer to challenge NAF award where consumer asserted that he had never consented to arbitration agreement); *Barbera v. AIS Services, LLC*, 897 N.E.2d 485 (Ind. Ct. App. 2008) (reversing trial court's refusal to vacate NAF award where consumer did not receive adequate service of process of the notice of claim and the notice of arbitration); *FIA Card Services, N.A. v. Richards*, No. 07-1513, 2008 WL 2200101 (Iowa Ct. App. May 29, 2008) (affirming vacatur of NAF arbitration award where consumer did not receive notice of arbitration and did not receive the participatory hearing he requested); *MBNA Am. Bank, N.A. v. Barben*, No. 92,085, 2005 WL 1214244 (Kan. Ct. App. May 20, 2005) (affirming vacatur of arbitration award issued by NAF and noting trial court's finding that delivery date on face of NAF award was "patently . . . shown to be untrue," given that neither NAF's director of arbitration nor the alleged debtor were present on the date on which the award was purportedly delivered by the director to the debtor); *Chase Bank USA, N.A. v. Leggio*, --- So. 2d ----, 2008 WL 5076449 (La. Ct. App. Dec. 13, 2008) (affirming trial court's denial of bank's petition to affirm NAF award where "Chase has not demonstrated that Leggio ever consented to arbitration"); *MBNA Am. Bank, N.A. v. Pacheco*, No. 1621-06, 2006 WL 2337964 (N.Y.

The circumstances of the instant case provide yet another example of NAF's shoddy and untrustworthy procedures. Because Respondent Anastasiya Komarova was not actually a party to the NAF arbitration in this case, the full extent of the deficiencies in the NAF process cannot be known. Nevertheless, the record plainly reflects NAF's bias and lack of care. The debt at issue, which NCA had purchased from MBNA, arose from a credit card account that had been opened by Christopher Propper, who was at one point engaged to a woman named Anastasia—not Anastasi<u>y</u>a—Komarova. Resp't's Br. 6. Propper listed his fiancée as an "authorized user" on the account, but she never signed the application and therefore, according to MBNA, was never legally responsible for any charges on the account. *Id.* Notwithstanding the fact that Anastasia Komarova *bore no responsibility for the debt*, NAF entered an arbitration award against her as well as against Propper. *Id.* at 13.

City Ct. Aug. 11, 2006) (denying MBNA's motion to confirm arbitration award that NAF had entered against alleged debtor because the alleged debtor had never been served with the notice of arbitration).

E. NAF IS WIDELY REGARDED AS DEEPLY BIASED AGAINST CONSUMERS

Because of the above facts, NAF is widely regarded as intractably biased against consumers. As Professor Bartholet phrased it, "bias in favor of the big corporate player and against the employee and consumer . . . is inherent in this form of arbitration." *Courting Big Business: The Supreme Court's Recent Decisions on Corporate Misconduct and Laws Regulating Corporations: Hearing Before the S. Comm. on the Judiciary*, 110th Cong. (2008) (statement of Prof. Elizabeth Bartholet, Harvard Law School) *available at* http://judiciary.senate.gov/hearings/hearing.cfm?id=3485 (select "Elizabeth Bartholet" from "Witness Testimony" menu). Consumers around the country have alleged that NAF's "profile is oriented toward the business and financial community and antagonistic to the rights of individual claimants and consumers." Mark Brunswick, *First Lady Leaves Job at Private Firm*, Star Trib. (Minneapolis), Apr. 13, 2007, at 1B. *See also* Ovaska, *3 Cases Cite Payday Lending: Consumer Groups Say Arbitration Clauses Deny People Recourse to Courts*, *supra*, News & Observer, Jan. 7, 2007 (noting lawsuit challenging arbitration on grounds that NAF "is a biased organization that caters to business"); Reilly, *Supreme Court Looks at Arbitration in Alabama Case This Week*, Mobile Reg., *supra*, Oct. 1, 2000, at A1 ("High on arbitration critics' watch list is the Minneapolis-based National Arbitration Forum."); Ward, *State Court Urged to Toss One-Sided Loan Arbitration*, Charleston Gazette & Daily Mail, *supra*, Apr. 4, 2002, at 5A ("Hedges alleges that the forum, a private company, almost always favors lenders because its business is dependent on being chosen by lenders to arbitrate loan cases.").

This bias is evidenced by nearly a decade of data about outcomes in NAF arbitration. These data demonstrate that NAF's system works as intended—that is, to speedily produce the judgment-ready awards requested by credit card companies and debt collectors. Before 2002, the only data about outcomes in NAF arbitration came from an Alabama case against credit card issuer First USA. Those data revealed that, out of nearly 20,000 cases where NAF reached a decision between 1998 and 2000, First USA prevailed in 99.6% of cases. *See* Mayer, *Win Some, Lose Rarely? Arbitration Forum's Rulings Called One-Sided*, Wash. Post, *supra*, Mar. 1, 2000, at E01. While First USA filed more than 50,000 cases against consumers, consumers filed only four against First USA. *Id.* These stark numbers led commentators to note that "[e]very indication is that the imposed arbitration clauses are nothing but a shield against legal accountability by the credit card companies." Samuel Issacharoff & Erin F. Delaney, *Credit Card Accountability*, 73 U. Chi. L. Rev. 157, 173 (2006).

More data became available in 2002, when California passed Code of Civil Procedure § 1281.96, which requires that private companies administering consumer arbitrations provide certain information to the public.[6] The analyses of these data are similarly stark. The San Francisco City Attorney noted that, of 18,075 consumer arbitrations that went to a hearing in California between January 1, 2003 and March 31, 2007, only 30—less than 0.2% of the total—yielded a victory of the consumer. Compl. ¶ 22, *People v. Nat'l Arbitration Forum, Inc.*, No. C6C-08-473569 (Cal. Super. Ct. filed Aug. 22, 2008). Even more strikingly, in "*each and every* case where a business entity brought a claim against a consumer and the matter was disposed of by hearing, the NAF arbitrator ruled in favor of the business entity—a 100% success rate that any litigant would be overjoyed to have." *Id.* Similarly, Public Citizen found that all but 15 of NAF's

[6] NAF strongly resisted complying with this law, which was designed to "level the information playing ground" so that consumers, as well as the powerful corporations that impose arbitration clauses in their consumer contracts, would have access to information about arbitrators' track records. *See* Pam Smith, *Arbitrators Attack Calif. Disclosure Law*, The Recorder, Oct. 18, 2005. As stated by the California Court of Appeal in *Mercuro v. Superior Court*, 116 Cal. Rptr. 2d 671 (Ct. App. 2002), the fact that a company "repeatedly appears before the same group of arbitrators conveys distinct advantages over the individual [consumer]. These advantages include knowledge of the arbitrators' temperaments, procedural preferences, styles and the like and the arbitrators' cultivation of further business by taking a 'split the difference' approach to damages." *Id.* at 678-79.

33,948 reported cases were labeled "collection cases," and 53% of those cases involved MBNA credit card accounts. Public Citizen, *The Arbitration Trap: How Credit Card Companies Ensnare Consumers*, *supra*, at 14.

Recently, two major lawsuits have been filed that attest to NAF's pervasive bias against consumers. In the first suit, the City of San Francisco, on behalf of the People of California, charged NAF with being "in the business of operating an arbitration mill, churning out arbitration awards in favor of debt collectors and against California consumers." Compl. ¶ 1, *People v. Nat'l Arbitration Forum*, No. C6C-08-473569 (Cal. Super. Ct. filed Aug. 22, 2008). City Attorney Dennis Herrera said in a statement that "[t]he lengths to which the [defendants] have gone to ensure that California consumers lose in arbitrations against debt collectors is shocking." Sam Zuckerman, *Suit Accuses Credit Card Service Firm*, S.F. Chron., Apr. 8, 2008, at D1.

The second lawsuit, *Ross v. Bank of America, N.A.*, alleged that a large number of banks—including Bank of America, Capital One, Chase Bank, Citibank, Discover Bank, HSBC Finance Corporation, and MBNA America Bank—"illegally colluded to force cardholders to accept mandatory arbitration clauses in their cardholder agreements." 524 F.3d 217, 220 (2d Cir. 2008). The complaint also challenged NAF's neutrality; it noted that NAF is used by "nearly every defendant" and that NAF "markets its services to companies in several industries as a way to lower potential costs from disputes with consumers." Oehlsen, *Mandatory Arbitration on Trial*, Credit Card Mgmt., *supra*, Jan. 1, 2006, at 38. The trial court had dismissed the plaintiffs' claims for lack of standing, but the Court of Appeals for the Second Circuit reversed, holding that the injury inflicted upon the market "from the banks' alleged collusion to impose a mandatory term in cardholder agreements," including the "reduction in choice and diminished quality of credit services," was sufficient to constitute an injury in fact. *Ross*, 524 F.3d at 223-24.

CONCLUSION

As a business, NAF depends on the creditors that choose it in their consumer contracts. Numerous articles, studies, and court decisions show that, to obtain and maintain its corporate clients, NAF routinely enters arbitration awards in favor of creditors and debt collectors and against consumers, even when those consumers never owed the debt or never agreed to arbitration. In light of this unique and troubling relationship, this Court must not permit debt collectors such as NCA to further benefit from this skewed system by leveraging arbitrations before NAF to immunize themselves from liability for violations of the Rosenthal Act.

Respectfully submitted this the ___ day of February, 2009,

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*157 CREDIT CARD ACCOUNTABILITY

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Let's say you decide to sue your credit-card company because of outrageous interest rates and fees and deceptive marketing practices. Suddenly you discover you can't do it. [FN1]

INTRODUCTION

Unsolicited credit card mailings are on the rise, [FN2] and consumer indebtedness has been increasing apace. Alongside the mounting levels of debt are fears that consumers misapprehend the consequences of cheap credit and that the marketing of credit cards preys on the inability of consumers to assess properly the likelihood that they will become prisoners of a compounding spiral of debt. [FN3] A great deal of the critical commentary has focused on the initial inducement of consumers into dependence on credit cards through liberal solicitations, no annual charges on the cards, and initial low rates of interest. The primary claim here, as articulated by Professor Oren Bar-Gill, has focused on the pricing mechanisms used by credit card companies to lure consumers into a haven of debt, one whose back-end charges make it all too likely that debt levels will become all-consuming. [FN4]

In this Essay, we shift the focus from the mechanisms by which consumers are drawn to the world of credit cards to the perils that await them in the land of plastic. A survey of reported cases dealing *158 with consumer claims against credit card companies reveals a number of practices that exacerbate the effects of credit card indebtedness and frustrate consumers' efforts to disentangle themselves from bad credit card deals. We use these challenged practices as examples of the potential consequences of credit card debt, even if they arise after the initial contractual inducement.

The risks associated with the ever-enlarging amount of available credit have been compounded by the creation of effective barriers against deterrence-based oversight of the credit card market. In Part I, we look at one convenient source of protection: the federal banking laws. These laws have been interpreted to provide exclusive regulatory power to the handful of states that have emerged as friendly fora for credit card companies. Thus, Delaware, South Dakota, Nevada, Arizona, Rhode Island, and New Hampshire - states that combined have only 4 percent of the population - are now home to credit card issuing banks that, as of 2003, were owed more than $350 billion of the $490 billion outstanding debt on American credit cards. [FN5]

The major development, however, is the inclusion of binding arbitration clauses by most major credit card companies in their agreements, a move designed to thwart any sort of ex post accountability for credit card companies. In Part II, we turn to the question of ex post accountability for those who structure the terms of credit card debt. Our concern here is neither with the terms of credit card offerings nor with the actual levels of consumer debt. Rather, as in all markets characterized by large sellers and relatively atomized consumers, there is the risk of improper practices that impose small, almost inconsequential costs on individuals but yield significant returns in the aggregate.

Although the proliferation of these binding *individual* arbitration clauses has begun to draw the attention of consumer activists, [FN6] only the most aware of consumer groups has entered the fray. [FN7] Although the focus of these groups is often on the perceived fairness - or unfairness - of arbitration itself, in Part III we look instead at the effect ***159** of binding individual arbitration on the possibility of consumer class actions aimed at unscrupulous credit card practices, and on the reluctance of courts to look beyond contractual formalism in confronting one-sided imposition of these terms.

I. LOCATION, LOCATION, LOCATION

When Chief Justice John Marshall decided *McCulloch v Maryland* [FN8] in 1819, the one fledgling national bank was weak and in danger of being smothered by taxes imposed by the individual states. Today, there are roughly 2,200 national banks, [FN9] robust and growing due to the National Bank Act [FN10] (NBA) and subsequent acts of Congress [FN11] that strengthened the federal banking system by capitalizing on the powerful ability, outlined by Marshall years before, [FN12] of the federal government to preempt rival state law. [FN13]

The core of the relevant preemption power is found in § 85 of the NBA, which permits national banks to charge "interest at the rate allowed by the laws of the State, Territory, or District where the bank is located ... and no more." [FN14] The term "located" proved to be a source of controversy, but in 1978 the Supreme Court significantly expanded its scope in *Marquette National Bank v First Omaha Service Corp.* [FN15] Under the *Marquette* doctrine, a national bank is deemed to be located in the state in which it is chartered and is accountable to the laws of that state for its commercial activities, even if such activities are conducted elsewhere. This allows for the "exportation" of the laws ***160** of one state to regulate conduct in some other state. As a result, banks are able to *choose* their interest rates by virtue of their location in one state, and then to export those rates to customers in other states. Moreover, under *Marquette*, other states are forbidden to and may be enjoined from attempting to apply their usury laws and other regulations to out-of-state banks. [FN16]

Marquette had a dramatic impact on the credit card industry. [FN17] Suddenly, states that offered favorable legal sanctuary, such as freedom from usury regulations, could entice credit card companies to relocate. [FN18] And, smaller states, with their impressionable legislatures, became prime candidates from which credit card companies could seek legal accommodations. *Marquette* allowed nationwide market gains from whichever state offered the most protective legal environment. To the contrary of Herbert Weschsler's famous invocation of the "political safeguards of federalism," [FN19] the ability of any state to capture federal preemption through the exportation of its home-state regulations resulted in small states being offered relatively large gains by imposing risks on out-of-state consumers. Any state with a small population would likely serve as an attractive candidate for being importuned with the promise of tax revenues and jobs, with the burden primarily shouldered by voiceless consumers in other states.

And so it came to be that, like Elvis impersonators to Las Vegas, credit card companies were drawn to South Dakota and Delaware. For ***161** example, by 1982, ten banks had a new, major presence in Delaware, and today, "lenders in Delaware hold 43 percent of total credit card loans made by insured depository institutions." [FN20] This movement proved quite lucrative to those states with permissive regimes and limited usury laws (if any). After deregulation, South Dakota's tax revenue from credit card issuing banks increased from $3.2 million in 1980 to $27.2 million in 1987; Delaware's went from $2.4 million to $40 million in the same time period. [FN21] For those states with more stringent regulations, the job flow has waned as companies leave. In 1997, North Carolina's Deputy Commissioner of Banks, estimated that the state had "experienced a loss of several thousand jobs over the years as state legislators refused to loosen credit card regulations." [FN22]

In 1996, the Supreme Court again expanded the exportation doctrine in *Smiley v Citibank*. [FN23] Adopting a definition suggested by the Office of the Comptroller of the Currency (OCC), the Court held "interest" to include any charges attendant to credit card usage. [FN24] As promulgated in OCC regulations, this would include, "numerical period rates, late fees, creditor-imposed not sufficient funds (NSF) fees ..., overlimit fees, annual fees, cash advance fees, and membership fees," among other things. [FN25] Despite ongoing efforts by some states to test credit card immunity from regulation outside their chartering states, [FN26] the predictable effect was to allow the most pliable states to serve as safe havens from regulation.

Thus, late fees went the way of interest rates, and states with permissive regimes continued to hold sway over the rest of the country. After 1996, credit card companies changed their pricing strategies, incorporating a wider variety of fees [FN27] and using variable interest rates. [FN28] ***162** The relaxation of state regulation on ancillary charges for credit cards provided an important new source of revenue for credit card issuers that was not as transparent and not as subject to competitive pressures as fixed charges or specified interest rates. Thus, it seems more than coincidental that the significant rise in late fee revenue has occurred at the same time as the fall - and for many, the eradication - of the highly transparent annual charge. [FN29] Beyond the possibilities for sharp dealing, such as having an unpublished cutoff time for payments (for example, 1 p.m. on the relevant day [FN30]), or holding payments received on the due date and crediting them the next day, credit card companies are also able to take advantage of consumer behavior that shows a high sensitivity to yearly fees and an overoptimistic attitude towards compliance with payment dates.

Behavioral literature suggests that companies should be expected to design contractual offers in anticipation of the predictable decisional heuristics of consumers, such as overconfidence. [FN31] Consumers appear highly attuned to annual charges, and those have largely passed from the scene in a highly competitive market. Similarly, the increasing salience of interest rates has given rise to a generation of "flippers," or, more colorfully, "rate tarts" - savvy consumers willing to switch their credit cards or swap their debt from credit card to credit card to take advantage of lower rate offerings. [FN32] In response, credit ***163** card companies have shifted their focus to increasingly less visible pricing schemes to achieve similar results and to forestall the normal profit contractions of a mature market. [FN33] Oddly, from the vantage point of a credit card holder, the older regime of an annual fee may well have been the better option. The average late fee in 2003 was $32. The average annual fee, on those few accounts subject to one, was $44.30. [FN34] Late fees, however, cost much more than the $32 payment. They trigger penalty rates - often considerable hikes in the cardholder's annual percentage rate (APR) - and they usually are tiered, with higher fees for higher balances overdue. [FN35] Consumer groups have suggested that this combination of late fees and penalty rates is convincing evidence of "anti-consumer policies employed by credit card companies to force cardholders to slide deeper into debt." [FN36] Some have even called for the return of the annual fee: "[I]ssuers wouldn't have such a scruffy image today if they had held the line of upfront annual fees instead of becoming so reliant on dinging their customers every time they disobeyed the increasingly strict rules." [FN37]

Regardless of the advocacy of consumer groups, late fees have tripled in the past decade, [FN38] and when coupled with related fees (such as overlimit fees) presently constitute a third of the income stream for credit card companies. [FN39] Controlling the late fee explosion through regulation is proving beyond the regulatory capacity of individual states. In ***164** early 2005, for example, Maine legislators tried to put together a bill that would protect consumers from "excessive" late fees. The effort was short-lived, and even the bill's sponsor recognized its inherent weakness: "[T]he bill [] would unfairly affect Maine-based banks because national credit card issuers would not be affected." [FN40] This suggests that the key to effective regulation is the ability to regulate the practices of national banks operating within the several states, rather than any individual state trying to regulate the small number of credit card issuers within its jurisdiction, as the Maine example demonstrates.

More significant, therefore, was the effort in California to alter the practices of all credit card offerings in that state with regard to one method credit card issuers have used to increase their revenues: the extension of the time necessary to pay off loans by reducing the monthly minimum payments. [FN41] For the substantial segment of the population that pays only the monthly minimum, [FN42] the reduction in the minimum payment produces an increase in indebtedness and associated interest charges, regardless of whether it improves the welfare of the cardholder. Professor Bar-Gill suggests this is an area in which credit card companies take advantage of and actually target "consumers' underestimation of the period it will take them to repay their credit card debt." [FN43] To that end, companies often design credit card bills so as to highlight the minimum payment rather than the total balance due. [FN44] In order to counteract the inducement to carry greater debt by paying only the minimum amount due, the California legislature passed a statute designed to require companies to warn credit card users about the length of time required and total cost incurred if the outstanding balance were to be repaid only by minimum balance ***165** incrementals. [FN45] This regulatory endeavor was quickly shut down under challenge by the American Bankers Association, with a court finding that the home laws of the issuing banks, operating with the national mandate of the NBA, preempted the California regulations.. [FN46]

The combined effect of these decisions was understood to "immunize credit card issuers from state consumer protection regulation." [FN47] Other than the likely captured home state regulators of the chartered banks, this leaves only the OCC with any potential regulatory oversight. Unfortunately, there is little evidence that the OCC either by design or operation is set up to be a consumer watchdog. Although the OCC has been taking a more proactive approach to policing the credit card industry, that is simply not its mandate: "Congress never granted to the OCC the authority to substitute what *it* believed best protected consumers for what duly elected legislatures believed best." [FN48] The OCC is not meant to be focused on consumer rights - just on strengthening the national banking industry.

In the era leading up to and just after *Swift v Tyson*, [FN49] a case that was intended to create national rules for the credit market, commentators bemoaned the fact that law had become "a science of *geography*, almost as much as of *justice*." [FN50] Justice Story's attempt to nationalize commercial law had unintended legal consequences that resulted in inconsistencies and inequalities among different states. [FN51] The return, after *Erie Railroad Co v Tompkins*, [FN52] of control to state law has not, ***166** however, solved the problem. [FN53] State law in small states like Delaware and South Dakota, through their policies on interest rates, late fees and, increasingly, no-class action clauses, now provides the rules for the credit industry. [FN54] In *McCulloch*, Chief Justice Marshall suggested that the people of one state should not be required to entrust the operations of the national bank to the people of another state; one can only marvel at how *McCulloch* has laid the foundation for individual states to set the terms of the national credit market. [FN55]

II. "GET OUT OF JAIL FREE" [FN56]

Parties who rely on others are, in all circumstances, imperfectly able to monitor the work of their agents. Thus, every principal-agent relationship is ripe for the exaction of agency costs; hopefully, market pressures will impose a competitive brake on their escalation as information spreads and other potential agents offer arrangements more profitable to the principal. However, the democratization of markets and their transformation into mass markets strains this simple contractarian story. Increasingly, the relations between large sellers and multiple small buyers becomes a world of contracts of adhesion, with terms and conditions set by the seller with no realistic prospect of negotiation. When markets prove not to have price competition, or when information is difficult to obtain and the transactional barriers to leaving one seller to find another are high, the risk of seller misbehavior is heightened. This is the story of many areas of consumer law, as the proponents of "asymmetric paternalism" have outlined. [FN57] The democratization of markets and the repeat nature of the seller's transactions give rise to the prospect of the incremental extra charge, the marginal ***167** defect in goods, the sleight of hand of the bait-and-switch, all of which are not worth the transactional headaches for the consumer to challenge. But when these small and seemingly insignificant market misbehaviors are spread over a broad consumer base, small charges mount into sizeable yields.

The credit card market is a perfect example of a democratized market. Once the sole purview of the wealthy and entrepreneurial classes, credit cards have brought the enhanced powers of leveraged debt to the masses. Credit cards may stimulate consumption and smooth intertemporal fluctuations in wages, but they also bring the specter of crushing debt. Critically, credit cards provide misbehaving sellers with the capacity for simple exploitation in a highly asymmetric market with little consumer bargaining power for those already on the hook.

The question is therefore what can be done to check misbehavior in circumstances where market mechanisms may prove to be insufficient. It would perhaps be possible to impose a strong form of regulation on credit card markets: terms and conditions could be fixed; the amount of credit to individuals limited; the general availability of credit cards curtailed. Cass Sunstein has described this sort of command-and-control regulation as "hard paternalism." [FN58] Although some issues may be successfully addressed via this option, major dislocations for a significant part of the economy would be created and the availability of credit for those who need it reduced. The goal of asymmetric paternalism is to find less intrusive forms of regulation that focused on the areas of decisionmaking where biases and deeply flawed heuristics might control, while leaving a broad range of decisionmaking to individuals cognizant of the consequences of their conduct. [FN59] This, per Professor Sunstein, is the domain of soft paternalism. In effect, soft paternalism searches for mechanisms to improve decisionmaking without having the state assume responsibility for all decisions, most typically on a one-size-fits-all basis.

Credit cards are a difficult area for this form of mildly paternalistic regulation because the most preferred of the weak regulatory options - disclosure - is likely to be insufficient. Most remedial efforts, such as the federal Truth in Lending Act (TILA) regulations, are ***168** aimed at providing more information about the potential pitfalls of credit. As one commentator has noted,

> [W]hether consumer behavior is influenced by the historical APR disclosure has no empirical confirmation. The consumer's decision to incur the cash advance fees was certainly not affected by this disclosure that took place well after those transactions, possibly by as much as a month. In short, the value of periodic aggregation and disclosure of finance charge fees, and computation of them into an historical APR, is considerably attenuated. [FN60]

A. Ex Post Accountability

Assuming the standard weak regulatory responses, such as disclosure, may have only slight utility, the question is what to do. At this point, it may be necessary to expand the arsenal of soft paternalistic responses to include mechanisms that offer protections ex post rather than ex ante. Focusing on ex post mechanisms - such as knowledge gained through repeat play or the availability of agents with incentives to counteract imperfect spot judgments - highlights a shortcoming in the behavioral literature. The behavioral critique of individual decision-making does not readily acknowledge how institutions and markets may mediate between cognitive error and irrational behavior. Thus, Richard Epstein writes:

> Over time, individuals will seek out others who have better knowledge than themselves to make critical decisions, at least as long as they have some recourse against fraud and other forms of misappropriation. Markets then are rational to the extent that, on average, the decisions to cede control or to share authority replace worse decision makers with better, leaving both sides to the deal better off than before. Perfection of outcome is simply too strict a condition to have any descriptive or normative relevance. [FN61]

One such possible institutional actor is the self-designated ex post agent, the entrepreneurial lawyer willing to aggregate claims of small disadvantaged consumers. In much of consumer law, such an agent, either from the private bar or through the parens patriae power or regulatory power of the state, is the sole potential agent for consumers ***169** "to seek out" - even if the seeking party is inverted. The question is whether ex post learning or access to an agent to challenge misbehavior ex post may be thought of as a companion mechanism to soft paternalism. Potential legal representatives armed with doctrines such as unconscionability may well provide sufficient smoothing in a market characterized by asymmetric bargaining power and access to information. But this assumes the availability of such legal representatives to provide ex post remedial assistance. Between the preemptive powers of captured state authority and prohibitions on collective action, the credit card companies have worked mightily to insulate themselves from corrective market actors.

Our concern, as we explain below, is the increased use of contractual terms in credit card offerings that require all disputes to be submitted to arbitration rather than litigation and that further prohibit any aggregated representation regardless whether the challenge goes forward in court or through arbitration. Accordingly, we may focus more directly on the question of compelled arbitration, in general, and compelled individual arbitration, in particular, in light of their relation to the ability to acquire agents capable of correcting consumer error ex post. It is of course possible to posit, as did Justice Blackmun in *Carnival Cruise Lines, Inc v Shute*, [FN62] a case concerning a forum selection clause in a contract of adhesion, that any contractual provision imposed by a seller in a form contract will be priced into the ultimate bargain realized by the consumer, through the mechanisms of market efficiencies. [FN63] Indeed, Professor Clayton Gillette offers this form of joint welfare gain as a major defense of the use of arbitration for dispute resolution in commercial ventures. [FN64] But these arguments assume precisely what is contested in the accounts of price insensitivity presented by Professor Bar-Gill, and disregard the bait-and-switch and lock-in problems that are often at issue in these cases. [FN65] Not only are these second-order considerations unlikely to capture consumer interest, they are also unlikely ever to become the source of market competition: "[N]o seller is likely to call attention to possible problems with its own product by telling consumers that 'if it explodes you can ***170** sue us in court, not just through an arbitration.'" [FN66] In addition, Professor Gillette properly notes the distinct vulnerability of the low value claimant faced with repeat players using arbitration as a shield:

> Even low-cost arbitration may be too expensive to justify initiation of a claim against a seller unless

the expected recovery is significant. Thus, consumers who fear that they will be unable to resolve postsale disputes with the seller may want to reserve a right to join a low-cost class action, or at least an opportunity to pursue low-cost small claims actions and actions under consumer protection laws, which commonly permit recovery of attorneys' fees. [FN67]

Yet the development of the credit card market has made the prospects of low-cost challenge to improper practices increasingly remote. The credit card companies have shown themselves to be agile and have moved more quickly than consumer accountability could anticipate in ways designed to forestall the emergence of agents of the sort Professor Epstein anticipates.

B. Gotcha!

A significant number of cases, brought for rather obvious reasons as class actions, bring to light practices that expose credit card holders to obligations arguably well beyond the initial contractual terms. The bait-and-switch technique is a frequent subject of litigation involving credit cards; for example, banks may use the "change in terms" clause in the Cardmember Agreement to change what at the outset were seemingly fixed terms. [FN68] It should be stressed that all of the fact patterns that we describe arise from relatively routine consumer cases in which purchasers assert that they did not obtain the benefit of the bargain into which they entered. These fact patterns also are typical of consumer cases in that they involve similarly situated recipients of uniform goods or services who find their claims joined through entre-preneurially-inspired class actions. What is the subject of concern, ***171** however, is the way in which the introduction of mandatory, individual arbitration changes the landscape significantly.

Consider, for example, the claim of Joseph Bellavia against First USA Bank for charging an undisclosed fee whenever cardholders exceeded their credit limit. [FN69] The underlying legal issue was whether such a practice would be unlawful if the "overlimit fee" were deemed part of the mandatory disclosure of finance charges. [FN70] Or consider the facts in the most recent case from the California Supreme Court involving the Discover card: unbeknownst to consumers, payments not credited by 1:00 p.m. on the due date were deemed late and subject to a $29 late fee plus finance charges. [FN71] The question there was whether the imposition of the hour limitation for the acceptance of payments was proper within the terms of the underlying card agreement. Each of these cases presented a straightforward question of law that would, if heard on the merits, apply equally to all similarly situated cardholders.

Perhaps even more typical among cases testing various credit card practices are challenges to unilateral changes in the terms of a credit card arrangement. In one illustrative case, an individual opened an account with Fleet which promised her a 7.99 percent fixed APR. The mandatory federal disclosure, known as the "Schumer Box" for the manner in which the information in the initial disclosure is presented, [FN72] strongly implied that the bank would only change the rate under two specific circumstances: "[F]ailure of the prospective cardholder to meet any repayment requirements, or closure of the account." [FN73] Here the challenge was whether unilateral changes in effective rates violated the federal TILA by "fail[ing] to ... disclose that the fixed-rate APR that it was offering was limited in duration and subject to its asserted contractual right to change the interest rate at ***172** any time," [FN74] a claim with sufficient apparent merit to survive summary judgment.

But, before the merits of the overlimit fee, the 1:00 p.m. cutoff, or the change in interest rates could be reached, the courts had first to confront the practical realities of whether these kinds of cases would ever be brought given the transaction costs barriers to any single person ever assuming the cost of individual prosecution. Not surprisingly, all the cases were brought as class actions. The key, however, to the overlimit and time-of-day cases was a second change made by First USA and Discover, pursuant to the amendment provisions in their cardmember agreements, which created a new agreement to arbitrate all credit card disputes. [FN75]

In the case of Bellavia, the requirement of individual arbitration created a perfect bind. Had Bellavia tried to reject the imposition of new fees by either refusing to accept the new arrangement or canceling his card, he would have been subject to another provision inserted by First USA. If the cardmember rejected the agreement, his "charge privileges would have been terminated and he would be required to pay off any unpaid balance, at which point the parties' relationship would cease." [FN76] Because many consumers presumably have unpaid balances because of a lack of liquidity, this particular provision put indebted consumers in a mild lockhold. Not surprisingly, Bellavia did not reject the new term, perhaps because of the inability to afford the right of exit.

As a result of failing to bail out of the new contract terms, Bellavia's only recourse was to bring legal challenge to the new charges. But here he became immediately subject to the First USA arbitration clause, which the court found - in conjunction with the company's offer to pay all arbitration costs - to be a prohibition on proceeding on a classwide basis. [FN77] The result is that a consumer complaining of ***173** mounting charges either is left to pay off immediately all outstanding charges on his account, or is given the opportunity to arbitrate a claim worth at most a few hundred dollars.

As the Bellavia case indicates, there is every reason to believe that consumers will both fail to comprehend the significance of these kinds of changes and will have no realistic prospect of acting upon this type of disclosure. [FN78] As cogently expressed by Professor Sternlight:

> [E]ven to the extent that consumers might read and understand an arbitration clause imposed on a predispute basis, psychologists have shown that predictable irrationality biases will prevent them from properly evaluating the costs and benefits of accepting such a clause. For example, because people tend to be overly optimistic, they will often underpredict the need they might have to bring a claim against a company and thus undervalue what they are losing by giving up a right to sue. Similarly, psychologists have shown that people are risk-seeking with respect to certain prospective losses. Given the motivation for profit maximization, it seems inevitable that, absent regulation, companies will seek to take advantage of consumers' irrational behavior by manipulating arbitration clauses together with other aspects of consumer contracts. [FN79]

Every indication is that the imposed arbitration clauses are nothing but a shield against legal accountability by the credit card companies. For example, in the first two years in which its contracts featured mandatory arbitration clauses, credit card issuer First USA filed 51,622 arbitration claims against card users, while only four consumers made a claim against the company. [FN80] As one defense counsel quipped in the parallel context of franchising agreements, "[A]n arbitration ***174** clause may not be an invincible shield against class action litigation, but it is surely one of the strongest pieces of armor available." [FN81]

The effect of the mandatory arbitration clause on class-wide consumer claims is evident in a variety of contexts. Regardless whether the challenge is to undisclosed costs of rolling over repeat borrowings (so-called "loan-flipping"), [FN82] an undisclosed extra charge of $15 for "vendor's single interest insurance" on the purchase of a cell phone, [FN83] or the "credit life insurance" provisions of a home loan agreement (running to thousands of dollars of extra charges), [FN84] the result is often the same. As one court stated in refusing a consumer request to disallow the imposition of binding individual arbitration, the plaintiff had failed to "carry her burden of showing either that Congress intended to create a non-waivable right to bring TILA claims in the form of a class action, or that arbitration is 'inherently inconsistent' with the TILA enforcement scheme." [FN85]

The ability of credit card companies to insert mandatory arbitration provisions into their cardmember agreements is not completely unfettered. In a challenge brought under the Fair Debt Collection Practices Act, one court held that "the type of change to cardholders' legal rights represented by the addition of an arbitration clause simply does not come within the bounds of that narrowly drawn" change-in-terms provision. [FN86] Some courts have held differently and supported *175 mandatory individual arbitration requirements under the change-in-terms provisions of consumer agreements; [FN87] moreover certain states have enacted statutes that allow arbitration clauses to be added through these change-in-terms provisions. [FN88] For example, all companies chartered in Delaware benefit from such a statute. [FN89] The role of an individual state in assisting credit card companies through state law is a critical aspect of the complicated overlay between federal and state law in providing refuge for credit card companies.

III. FUNCTIONAL UNCONSCIONABILITY

Although some "no-class-action arbitration clauses" have been successfully challenged on grounds of unconscionability [FN90] and of cost-*176 spreading, [FN91] this remains a minority view. [FN92] Despite the fact that the arbitration clauses are imposed in a more or less take-it-or-leave-it fashion and are often accompanied by punitive provisions for attempting to exit the contract, courts have inquired only whether the terms are clearly stated somewhere in the cardholder agreement. For these courts, it is enough that there be an aura of informed consent around the prohibition on aggregation of claims. [FN93] Other courts have rejected unconscionability analysis based on the view of a class action as merely a procedural right. [FN94] The minority view, however, has looked beyond the formal symmetry of the deal to demand that legal redress for misbehavior be realistically available. [FN95] For example, in a West Virginia*177 case about credit liability insurance, the court found the arbitration provision unconscionable, explaining:

> [I]n the contracts of adhesion that are so commonly involved in consumer and employment transactions, permitting the proponent of such a contract to include a provision that prevents an aggrieved party from pursuing class action relief would go a long way toward allowing those who commit illegal activity to go unpunished, undeterred, and unaccountable. [FN96]

The key to this decision is finding unconscionability not in the substantive terms of the exchange but in the procedures realistically available for policing misconduct after the fact. Under the facts presented, the court had to be attuned to the reality that the individual seeking to act as class representative was suing for a grand total of $8.44. [FN97] No matter how cost effective arbitration might be, such small claims simply are not viable as a matter of individual arbitration and stand as effective buffers against any kind of accountability for practices perceived to be unfair. [FN98] And these low-cost claims - termed "negative value" claims in the class action argot [FN99] - which in the aggregate could equal hundreds of thousands (if not millions) of dollars, are precisely the type of claims that class action litigation was designed to facilitate. [FN100]

*178 The legal landscape has been altered most significantly by the recent decision of the California Supreme Court in *Discover Bank v Superior Court*. [FN101] The key insight here is to tie the substantive acceptability of a contract term to the comparative ability of the parties to enforce their contractual expectations. Accordingly, the court held, "[C]lass action waivers found in [adhesion] contracts may [ ] be substantively unconscionable inasmuch as they may operate effectively as exculpatory contract clauses that are contrary to public policy." [FN102]

Although most courts to date have found such mandatory individual arbitration clauses to be procedural by nature and therefore not subject to unconscionability analysis, [FN103] the California Supreme Court focused on the distinct combination of a contract of adhesion and the unlikelihood that any consumer claim could be enforced absent a collective prosecution. In fact, the court stated clearly that "class actions and arbitrations are, particularly in the consumer context, often inextricably linked to the vindication of substantive rights." [FN104] Accordingly, the court concluded, "Such 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." [FN105]

The key insight of the California Supreme Court is to view arbitration clauses from a functional perspective, one that assesses both the vulnerability of consumers in particular contractual relations (such as through credit cards) *and* the availability of meaningful means of redress. The court neither holds all class action waivers unconscionable nor condemns the voluntary arbitration of consumer claims. Rather, the court focuses on the procedural means through which the waiver of collective enforcement is obtained (the "bill stuffer" notice ***179** sent to consumers in bulk) and the likely consequence on the enforcement of substantive rights.

Revealingly, the prospect of classwide arbitration, now established under California law, [FN106] makes transparent that the concern of the credit card companies is about collective enforcement, not about the purported jointly beneficial savings from arbitration. There is some support by states, [FN107] to engage in classwide arbitration. [FN108] Credit card companies have shown themselves to be even less enthusiastic about classwide arbitration than about class action litigation. The "devil you know" phenomenon is compounded by the uncertainty of judicial review of class certification in arbitration and the concomitant fear of a "renegade arbitrator" certifying a class and exposing a company to massive liability. [FN109] Thus,

> Discover Card recently amended its clause to provide that "if the Class Action Waiver set forth above in the Arbitration of Disputes section is invalidated in any proceeding in which you and we are involved, then the Arbitration of Disputes section will be void with respect to that proceeding." In other words, if Discover can't compel individual arbitration, it doesn't want to be in arbitration at all. [FN110]

***180** Other companies have tried to effect similar results, though with less direct language. [FN111]

The legal question then becomes whether the impediments to collective enforcement mechanisms are of sufficient consequence to invite exacting judicial scrutiny. [FN112] This claim is an uphill battle given that the U.S. Supreme Court has not only rejected the claim that inequality of bargaining power itself may doom a mandatory arbitration clause, [FN113] but has repeatedly endorsed a strong preference for private dispute resolution. Nonetheless, even the Court's early exposition of the desirability of arbitration tied the preferability of the private forum to the ability to vindicate substantive rights:

> By agreeing to arbitrate a statutory claim, a party does not forgo the substantive rights afforded by the statute; it only submits to their resolution in an arbitral, rather than a judicial, forum. It trades the procedures and opportunity for review of the courtroom for the simplicity, informality, and expedition of arbitration. [FN114]

Subsequently, the Court further cautioned that the use of the arbitral forum must not impede the function of the substantive right at issue: "So long as the prospective litigant effectively may vindicate its statutory cause of action in the arbitral forum, the statute will continue to serve both its remedial and deterrent function." [FN115] The question is what constitutes "effectiveness" for purposes of preserving core substantive rights. Thus it may be that, as Linda Demaine and Deborah Hensler suggest in their study of the "Average Joe" in California, the wording of predispute arbitration clauses and the paucity of information*181 available to consumers on their meaning and import results in a playing field "strongly tilt[ed]... in the business's favor." [FN116] But that alone does not appear to suffice to demonstrate a disqualifying lack of effectiveness of arbitration.

Some lower courts have seized upon the concept of "effectiveness" as a way of annulling arbitration clauses that preclude collective action. One district court in Delaware, for example, found that prohibiting a class action for a claim under the TILA would frustrate the purposes of the Act: "[W]ithout a guarantee that [the plaintiff] may 'effectively ... vindicate his statutory cause of action in the arbitral forum,' it is questionable that the 'statute will continue to serve both its remedial and deterrent function.'" [FN117] Some courts interpreting state law have also voided arbitration clauses in situations where the underlying statute expressly authorized the right to bring a class action. [FN118]

Yet these decisions have until recently been outliers. The decision by the Delaware district court was overturned by the Third Circuit on the basis that TILA had not created a substantive right to a class action. [FN119] The Supreme Court's decision in *Gilmer v Interstate/Johnson *182 Lane Corp*, [FN120] suggests the same is true about the Age Discrimination in Employment Act (ADEA): "Even if the arbitration could not go forward as a class action or class relief could not be granted by the arbitration, the fact that the [ADEA] provides for the possibility of bringing a collective action does not mean that individual attempts at conciliation were intended to be barred." [FN121] The critical question, therefore, is whether there is any basis for including the ability to bring consumer claims collectively against credit card companies as a substantive right, per *Gilmer*.

As indicated by the California Supreme Court in the *Discover* litigation, this is now a key area of contention if ex post accountability is to remain a weak form of regulatory review of the burgeoning credit card market.

CONCLUSION

The ultimate question raised by this Essay is whether a guarantee of ex post review can be fitted within a soft paternalistic regime. Although not developed in *Discover*, the reasoning of the California Supreme Court fits comfortably with both the insights of Professor Bar-Gill, concerning the initial vulnerability of credit card consumers, and of Professor Epstein, extolling the ability of experience and agents to overcome initial heuristic errors. The California Supreme Court's approach neither commands a particular form of consumer regulation nor leaves the matter entirely to contractual formalism. Instead, consistent with the approaches of soft paternalism, the regulatory response also facilitates effective after-the-fact responses. For those consumers who realized the benefit of the bargain, no credit card practices are deemed per se unacceptable. On the other hand, systematic misestimations of cost or propensity to late fees may be redressed, either by learning or by legal challenge if the practices are indeed beyond the scope of conscionability.

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[FN1]. Robert Heady, *Credit Card Companies Push Consumers into Arbitration*, San Gabriel Valley Trib (California) (Dec 31, 2004).

[FN2]. Solicitations reached approximately 4.9 billion (39 per household) in 2001, according to Julie Williams, First Senior Deputy Comptroller and Chief Counsel at the Office of the Comptroller of the Currency (OCC). Julie L. Williams, *Remarks before the Mid-Atlantic Bank Compliance Conference* 1, 2 (Mar 22, 2002), online at http://www.occ.treas.gov/ftp/release/2002-30a.doc (visited Jan 6, 2006) (describing banks' recent efforts to create income from sources other than interest, and citing the recent large scale credit card solicitations as evidence of new marketing techniques).

[FN3]. See Oren Bar-Gill, *Seduction by Plastic*, 98 Nw U L Rev 1373, 1420-21 (2004) (arguing that "[i]ndividuals tend to make fewer mistakes when a decision involves higher costs," and that the unsolicited nature of credit card offers suggests they are inexpensive, leading to less consumer vigilance).

[FN4]. See id at 1401-08 (describing various credit card pricing techniques, such as use of teaser rates and no annual or per transaction fees, that tend to lure consumers into taking on credit card debt).

[FN5]. Mark Furletti, Comment, *The Debate over the National Bank Act and the Preemption of State Efforts to Regulate Credit Cards*, 77 Temple L Rev 425, 443 (2004) (discussing the ramifications of liberalized state lending statutes).

[FN6]. For example, a coalition of consumer groups has started a "Give Me Back My Rights" campaign to encourage consumers to seek out the few credit card companies that do not compel arbitration and switch to their cards. See *Give Me Back My Rights Campaign*, online at http://www.stopBMA.org/bma-about.htm (visited Jan 6, 2006) (naming the founding members of the coalition that is working to eliminate binding mandatory arbitration clauses, and providing information on the issue).

[FN7]. See Michael D. Sorkin and Ed Ronco, *Consumer Groups Decry Growing Use of Arbitration*, St Louis Post-Dispatch A1 (Feb 25, 2005) ("Many have no idea they've ever agreed to binding arbitration, by passively accepting a densely worded agreement in tiny type.").

[FN8]. 17 US (4 Wheat) 316 (1819).

[FN9]. See Clyde Mitchell, *OCC Preemption: What's the Problem?*, 231 NY L J 3, 3 (Mar 17, 2004) (discussing the conflict that arises when state legislatures attempt to "regulate the activities of [] national bank[s] operating within [their] borders").

[FN10]. See 13 Stat 99, 108 (1864), codified at 12 USC § 85 (2000) (authorizing banks to charge interest on loans that they make).

[FN11]. See Riegle-Neal Interstate Banking and Branching Efficiency Act, Pub L No 103-328, 108 Stat 2338 (1994), codified at 12 USC § 1811 (2000) (establishing the Federal Deposit Insurance Corporation to insure the deposits of banks and savings associations); Gramm-Leach-Bliley Act, Pub L No 106-102, 113 Stat 1338 (1999) (providing a framework for the affiliation of various financial institutions to enhance competition).

[FN12]. See *McCulloch*, 17 US (4 Wheat) at 427 (holding that a Maryland law imposing a tax on the Bank of the United States was unconstitutional because the states lacked the authority to impose such a burden on the federal government).

[FN13]. See Elizabeth R. Schlitz, *The Amazing, Elastic, Ever-Expanding Exportation Doctrine and Its Effect on Predatory Lending Regulation*, 88 Minn L Rev 518, 521-22 (2004) (illustrating how the exportation doctrine's application significantly increases the "participation of mainstream financial institutions ... in the subprime loan market" because it allows federal rules to preempt state predatory lending laws).

[FN14]. 12 USC § 85.

[FN15]. 439 US 299 (1978) (holding that the NBA was enacted with the intent that banks be subject to the laws of the state in which they are chartered).

[FN16]. See id at 318 n 31.

[FN17]. Federalism concerns compound the problem of the prohibition on class actions, as will be discussed throughout. Although class action mechanisms are available under the deceptive business practices statutes of most states, federal preemption threatens to eviscerate this procedural device based on the home state law of a chartered bank. See John A. Marold, *Third Circuit's Decision in* Roberts v. Fleet Bank: *Thinking Outside of the "Schumer Box" or "Consumerism Gone Berserk"?*, 8 NC Banking Instit 399, 412 (2004) (describing *Roberts* decision as requiring federal preemption of Rhode Island's Unfair Trade Practices and Consumer Protection Act).

[FN18]. There exists an enormous literature on the extent of the competition for corporate reorganizations among states, which attract corporations by offering more favorable legal regulations. See for example Robert K. Rasmussen and Randall S. Thomas, *Timing Matters: Promoting Forum Shopping by Insolvent Corporations*, 94 Nw U L Rev 1357, 1363 (2000) (arguing that forum shopping in bankruptcy cases provides an incentive for jurisdictions to craft better legal rules). The extent of such competition is mitigated by the unwillingness of sophisticated capital markets to limit the amount of exploitation that any particular legal regime may offer. In all likelihood, the competition for credit card companies is more direct than that for corporations, because there are not sophisticated financial institutions monitoring the impact of various incorporation regimes on the investment quality of securities based on different state laws.

[FN19]. Herbert Wechsler, *The Political Safeguards of Federalism: The Role of the States in the Composition and Selection of the National Government*, 54 Colum L Rev 543, 546-47 (1954) (arguing that the independence of state governments is an integral component of our federalist system). See also Larry D. Kramer, *Putting the Politics Back into the Political Safeguards of Federalism*, 100 Colum L Rev 215, 233-34 (2000) (reassessing Wechsler's argument in light of the role of national political parties).

[FN20]. Diane Ellis, *The Effect of Consumer Interest Rate Deregulation on Credit Card Volumes, Charge-Offs, and in the Personal Bankruptcy Rate*, Bank Trends 98-05 (FDIC, Mar 1998), online at http://www.fdic.gov/bank/analytical/bank/bt_9805.html (visited Jan 6, 2006).

[FN21]. *Small Us Usurious*, Economist 26 (July 2, 1988) (discussing the massive increase in credit card debt in South Dakota and Delaware on account of usury ceiling deregulation).

[FN22]. Amanda K.S. Hill, Note, *State Usury Laws: Are They Effective in a Post-GLBA World?*, 6 NC Banking Instit 411, 427 (2002) (discussing the tradeoff between protecting the state's citizens by maintaining strict usury limits and causing other citizens to lose jobs in the credit card market as companies move to states that have looser regulations).

[FN23]. 517 US 735 (1996).

[FN24]. Id at 747 (holding that the statutory interpretation of 12 USC § 85 supported by the OCC was not unreasonable, and was thus entitled to deference).

[FN25]. 12 CFR 7.4001(a) (2005).

[FN26]. These states include, among others, California, Illinois, Indiana, New York, and Vermont. See Nicole Duran, *OCC: States' Enforcers Subject to Preemption*, Am Banker 1 (Dec 3, 2002) (describing the OCC's attempts to intervene when certain states investigate or threaten to bring actions against banks).

[FN27]. One often cited example is the "currency-conversion fee," which is a charge for "the benefit of using the card" abroad, according to a spokesman for Visa. Christopher Elliott, *A Fee Even the Card Issuers Cannot Explain*, NY Times C8 (June 14, 2005) (arguing that the currency-conversion fee is unjustifiable and providing anecdotes regarding the author's inability to obtain explanatory information about the fees from credit card companies).

[FN28]. See *The Profitability of Credit Card Operations of Depository Institutions*, An Annual Report by the Board of Governors of the Federal Reserve System (Aug 1997), online at http:// www.federalreserve.gov/boarddocs/rptcongress/creditcard/1997/default.HTM (visited Jan 6, 2006) ("[M]any issuers have also moved to variable-rate pricing that ties movements in their interest rates to a specified index such as the prime rate.").

[FN29]. For example, only 13 percent of cardholders are subject to annual charges. See James J. Daly, *Smooth Sailing*, 17 Credit Card Mgmt 30, 34 (May 2004).

[FN30]. See *Discover Bank v Superior Court*, 36 Cal 4th 148, 30 Cal Rptr 3d 76, 78 (2005) ("The credit cardholder ... alleges that Discover Bank had a practice of representing to cardholders that late payment fees would not be assessed if payment was received by a certain date, whereas in actuality they were assessed if payment was received after 1:00 p.m. on that date.").

[FN31]. See Jon D. Hanson and Douglas A. Kysar, *Taking Behavioralism Seriously: The Problem of Market Manipulation*, 74 NYU L Rev 630, 654-66, 722 (2002) (discussing common consumer behavioral tendencies, such as "false self-confidence" and the "optimistic bias," in addition to a larger set of heuristics, and suggesting that manufacturers should be able to prey on these biases to influence consumer preferences); Stefano Della Vigna and Ulrike Malmendier, *Overestimating Self-Control: Evidence from the Health Club Industry* 5 (Stanford Graduate School of Business Research Paper 1880, 2003), online at http://gsbapps.stanford.edu/researchpapers/library/RP1800.pdf (visited Jan 6, 2006) (finding evidence of consumer time inconsistency and overconfidence in the market for three U.S. health clubs and positing that health clubs exploit these tendencies via their contractual offerings).

[FN32]. In the United Kingdom, such consumers are called "rate tarts." Jim Stanton, *Why Moneyquest is in Love with Rate Tarts*, Evening News (Edinburgh) 4 (Nov 3, 2005).

[FN33]. Penalty fees contributed to only 16.1 percent of total revenue in 1996. By 2003, fees made up 33.4 percent of total revenue. In the same time period, the disclosure statements have grown from an average of one page to an average of twenty, with some cardmember agreements running as long as seventy pages. See Mitchell Pacelle, *Growing Profit Source for Banks: Fees from Riskiest Card Holders*, Wall St J A1 (July 6, 2004) ("Instead of cutting these people off as bad credit risks, banks are letting them spend - and then hitting them with larger and larger penalties for running up their credit, going over their credit limits, paying late and getting cash advances from their credit cards."). Robert McKinley, CEO of CardWeb.com, is quoted as saying, "As competitive pressure builds on the front-end pricing, it has pushed a lot of the profit streams to the back end of the card - to these fees." Id.

[FN34]. Daly, 17 Credit Card Mgmt at 34 (cited in note 29) (citing many statistics collected from credit card companies in 2004, including cost of funds, net chargeoffs, and average annual fee, which had increased from $43.73 in 2002).

[FN35]. *Credit Card Late Fees Rising*, 3 Cardline No 49, 1 (Dec 5, 2003) (describing the results of a recent survey).

[FN36]. *New Credit Card Survey Uncovers Increases in Anti-Consumer Practices*, Ascribe Newswire (May 24, 2004) (describing a 2004 Consumer Action study detailing a number of questionable credit card company practices, including high late fees and high interest rates).

[FN37]. James J. Daly, *Mourning the Annual Fee*, 17 Credit Card Mgmt 4, 4 (Sept 2004) (describing recent public upheaval regarding high credit card fees).

[FN38]. Megan Johnston, *Stop Getting Nicked by Late Fees*, 34 Money 45, 45 (Mar 2005).

[FN39]. Miles Rapoport and Andrew Fleischmann, *Yes, Virginia, There Is a Credit Card Late Fee*, The Record (Bergen County, NJ) L15 (Dec 23, 2003) (showing that in 2003, credit card companies were expected to reap approximately $40 billion in fees versus approximately $80 billion in interest charges). Income from late fees has grown by almost 400 percent in the past decade. See id.

[FN40]. Deborah Turcotte, *State Begins Looking into Credit Card Fees*, Bangor Daily News A5 (Jan 26, 2005) (summarizing the state legislature's proceedings on possible credit card regulations and suggesting that consumers simply need to treat contractual negotiations with credit card companies more carefully, as the bills are unlikely to pass).

[FN41]. See California Credit Card Payment Warning Act, Cal Civ Code § 1748.13 (West 2001) (requiring credit card bills to provide information regarding the length of time consumers have to pay off their balances by paying the minimum), declared unconstitutional in *American Bankers Association v Lockyer*, 239 F Supp 2d 1000, 1020 (ED Cal 2002) (holding the California law preempted by federal law). See also Bar-Gill, 98 Nw U L Rev at 1394 (cited in note 3) (arguing that although at first blush it might seem that low minimum monthly payments benefit consumers, they actually benefit card issuers because it "increase[s] the time it takes to repay the loans and hence the total interest eventually paid").

[FN42]. See Bar-Gill, 98 Nw U L Rev at 1394 n 108 (cited in note 3) ("Paying the minimum is a common phenomenon.").

[FN43]. See id at 1408 (explaining that this is compounded by their further underestimation of their future borrowing).

[FN44]. Id ("For instance, the 'minimum payment' box is often closer to the 'actual payment' box and emphasized with a distinct color or font size, while the total payment figure is the only figure appearing on the payment stub.").

[FN45]. Cal Civ Code § 1748.13 (mandating that credit card issuers include a number of written statements on credit card bills that notify the consumer of the potential ramifications of making only the minimum payment, such as describing exactly how long it will take a consumer to pay off balances of varying amounts).

[FN46]. *Lockyer*, 239 F Supp 2d at 1018 (deferring to the opinion of the OCC, which deemed Cal Civ Code § 1748.13 to be overly burdensome to card issuers and a "significant interference with the national banks' powers").

[FN47]. Furletti, Comment, 77 Temple L Rev at 446 (cited in note 5) (arguing that *Lockyer* is an important decision because it was one of the first cases in which a state's "effort to enforce a non-price-related consumer protection" was preempted).

[FN48]. Nicholas Bagley, Note, *The Unwarranted Regulatory Preemption of Predatory Lending Laws*, 79 NYU L Rev 2274, 2309 (2004) (arguing that the OCC's justification of its regulatory preemption of state predatory lending laws is misfounded partly because Congress never granted such authority to the OCC, but also because it has never been proven that state predatory lending laws are in fact "more costly than beneficial").

[FN49]. 41 US (16 Pet) 1 (1842).

[FN50]. John William Wallace, *The Want of Uniformity in the Commercial Law between the Different States of Our Union*, Discourse Delivered before the Law Academy of Philadelphia 1, 28 (Nov 26, 1851).

[FN51]. See *Black and White Taxicab and Transfer Co v Brown and Yellow Taxicab and Transfer Co*, 276 US 518, 535 (1928) (Holmes dissenting) (arguing that Justice Story's opinion placed too great a constraint on state laws).

[FN52]. 304 US 64 (1938).

[FN53]. For a further discussion of this point, see generally Samuel Issacharoff and Catherine M. Sharkey, *Backdoor Federalization: Grappling with "Risk to the Rest of the Country,"* 53 UCLA L Rev (forthcoming 2006).

[FN54]. See Barry Friedman, *Valuing Federalism*, 82 Minn L Rev 317, 407 (1997) (showing that policies of some states will affect other states and using the example of a loose environmental policy of one state causing pollution in bordering states).

[FN55]. See 17 US (4 Wheat) at 431 (arguing that because citizens of one state would not trust those of another with even the "most insignificant operations of their state government," it only follows that they would not trust another state to "control the operations of a government to which they have confided their most important and most valuable interests").

[FN56]. This quotation comes from *Szetela v Discover Bank*, 97 Cal App 4th 1094, 118 Cal Rptr 2d 862, 868 (2002), in which the court describes the arbitration prohibition against class actions, the subject of this section, as in effect "granting Discover a 'get out of jail free' card while compromising important consumer rights."

[FN57]. Colin Camerer, Samuel Issacharoff, George Loewenstein, Ted O'Donoghue, and Matthew Rabin, *Regulation for Conservatives: Behavioral Economics and the Case for "Asymmetric Paternalism,"* 151 U Pa L Rev 1211, 1230-37 (2003) (discussing a number of potential regulatory policies that could help prevent consumers from falling prey to sellers' attempts at framing their products in ways that take advantage of consumers' behavioral tendencies).

[FN58]. Cass R. Sunstein, *Boundedly Rational Borrowing*, 73 U Chi L Rev 249, 268 (2006) (arguing against broad-sweeping hard paternalism because of private heterogeneity and potential government errors, but admitting that hard paternalism might be desirable if applied to particular practices, like late fees and teaser rates).

[FN59]. See Camerer, et al, 151 U Pa L Rev at 1221-23 (cited in note 57) ("An attentiveness to minimizing costs to rational actors while maximizing benefits to boundedly rational actors fits well within a richer conception of efficiency.").

[FN60]. Ralph J. Rohner and Thomas A. Durkin, *TILA "Finance" and "Other" Charges in Open-End Credit: The Cost-of-Credit Principle Applied to Charges for Optional Products or Services*, 17 Loyola Consumer L Rep 137, 145 (2005).

[FN61]. Richard A. Epstein, *Second-Order Rationality*, in Edward J. McCaffery and Joel Slemrod, eds, *Behavioral Public Finance: Toward a New Agenda* 355, 365 (Russell Sage forthcoming 2006) (arguing that markets can be rational even if no individual actor is perfectly rational).

[FN62]. 499 US 585 (1991).

[FN63]. See id at 594 ("It stands to reason that passengers who purchase tickets ... benefit in the form of reduced fares.").

[FN64]. See Clayton P. Gillette, *Rolling Contracts as an Agency Problem*, 2004 Wis L Rev 679, 700 (arguing that arbitration clauses do not evince sellers' exploitation of consumers, but rather divide consumers into different categories - those who are willing to pay higher prices for contracts without arbitration clauses and those who are not).

[FN65]. See Part II.B.

[FN66]. Jean Sternlight, *Panacea or Corporate Tool?: Debunking the Supreme Court's Preference for Binding Arbitration*, 74 Wash U L Q 637, 692 (1996) (countering the argument espoused by "free marketeers" that sellers might start to compete on arbitration clauses).

[FN67]. Gillette, 2004 Wis L Rev at 700 (cited in note 64). In addition, even for actions of sizeable claims, "the degree to which prohibitions on class relief result in lower costs to consumers is an empirical question, and, so far, no empirical data exists." Thomas Burch, *Necessity Never Made a Good Bargain: When Consumer Arbitration Agreements Prohibit Class Relief*, 31 Fla St U L Rev 1005, 1028 (2004).

[FN68]. See, for example, *Roberts v Fleet Bank*, 342 F3d 260, 268 (3d Cir 2003) (finding defects in the original solicitation letter to the consumer); *Rossman v Fleet Bank*, 280 F3d 384, 398 (3d Cir 2002) (finding that as a result of the bait and switch tactic, the plaintiff "entered the agreement without the benefit of disclosure" of what the bank intended to charge).

[FN69]. *Bellavia v First USA Bank*, 2003 US Dist LEXIS 18907, *3 (ND Ill) ("[The plaintiff] allege[d] that First USA violated the Truth in Lending Act ... by failing to disclose on his credit card statements that the 'overlimit fees' that First USA assessed were part of the finance charges.").

[FN70]. See id. The issue litigated was the motion to compel arbitration over the claim. The underlying question of whether an overlimit fee constitutes a finance charge was resolved in the negative by the Supreme Court in 2004. See *Household Credit Services, Inc v Pfennig*, 541 US 232, 242 (2004) (holding that Regulation Z's exclusion of overlimit fees from the term "finance charge" is in no way contrary to § 1605 of TILA).

[FN71]. *Discover Bank v Superior Court*, 36 Cal 4th 148, 30 Cal Rptr 3d 76, 78 (2005).

[FN72]. See Fair Credit and Charge Card Disclosure Act, Pub L No 100-583, 102 Stat 2960, 2967 (1980), codified in part at 15 USC §§ 1610(e), 1637(c) (2000) (describing the disclosure requirements that credit card companies must follow when soliciting applications).

[FN73]. *Roberts*, 342 F3d at 263, 266 (describing the instances in which the defendant could alter the fixed interest rate that the parties had agreed to).

[FN74]. Id at 262. The appellate court accepted the change-in-terms provision: "Fleet clearly had the right to change the APR under the terms of the Cardholder Agreement." Id at 270 (finding "nothing ambiguous" in Fleet's statement that it reserved the right to alter the interest rate). The court, however, held that the provision failed "to cure any of the TILA defects in the initial mailing." Id at 268.

[FN75]. See *Bellavia*, 2003 US Dist LEXIS 18907 at *2 ("The Cardmember Agreement ... contains a provision that allows First USA to make amendments to the parties' agreement at any time ... [Pursuant to this provision,] First USA amended the terms of the Cardmember Agreement to include a new arbitration provision."); *Discover Bank*, 30 Cal Rptr at 79.

[FN76]. *Bellavia*, 2003 US Dist LEXIS 18907 at *3 (stating that because of the existence of this additional provision, the plaintiff "declined to reject the amended terms [of the agreement] and instead continued to use his credit card" until he filed his action alleging violations of TILA).

[FN77]. Id at *6-7 ("[The plaintiff] points to no precedent suggesting that the substantive right he seeks to vindicate - adequate disclosure of credit terms - is not arbitrable, and to the contrary, courts have consistently found that there is no legal impediment to arbitration agreements covering statutory claims arising under the TILA.").

[FN78]. See Linda J. Demaine and Deborah R. Hensler, *"Volunteering" to Arbitrate through Predispute Arbitration Clauses: The Average Consumer's Experience*, 67 L & Contemp Probs 55, 57 (2004) (examining "the frequency with which the average consumer encounters arbitration clauses, the key provisions of these clauses and the implications of these clauses for consumers who subsequently have disputes with the businesses they patronize"). "This study provides little basis for believing that consumers are making informed decisions when they 'agree' to arbitrate .... More than a third of the clauses obtained fail to inform consumers that they are waiving their right to litigate disputes in court." Id at 73.

[FN79]. Jean R. Sternlight, *Creeping Mandatory Arbitration: Is it Just?*, 57 Stan L Rev 1631, 1649 (2005).

[FN80]. Id at 1655 (countering the argument that mandatory arbitration clauses actually benefit the consumer by making it easier for them to file claims against issuers).

[FN81]. Edward Wood Dunham, *The Arbitration Clause as Class Action Shield*, 16 Franchise L J 141, 142 (1997) (summarizing class action cases that have arisen over the past decade in the context of mandatory arbitration agreements). See also Myriam Gilles, *Opting Out of Liability: The Forthcoming Near-Total Demise of the*

Modern Class Action 30 (Cardozo L Sch Working Paper No 100, 2004), online at http://ssrn.com/abstract=624002 (visited Jan 6, 2006) ("[C]orporate lawyers created the collective action waiver and wrapped their newborn in the cloak of an arbitration clause, protecting it against attack with the now-sacrosanct policies of the [Federal Arbitration Act].").

[FN82]. See *Livingston v Associates Finance, Inc*, 339 F3d 553, 554, 558 (11th Cir 2003) (remanding a dispute to arbitration on the basis of an arbitration agreement signed with the last of a series of loans).

[FN83]. See *Randolph v Green Tree Financial Corp*, 991 F Supp 1410, 1415 (MD Ala 1998), revd, 178 F3d 1149 (11th Cir 1999), revd in part, affd in part, 531 US 79 (2000). The plaintiff brought an action contesting the imposition of "an extra charge for insurance each year in the approximate amount of $15.00," but the Supreme Court held that her claim was subject to the mandatory arbitration agreement that she had previously signed. See 531 US at 92.

[FN84]. See *Gras v Associates First Capital Corp*, 346 NJ Super 42, 786 A2d 886, 888 (2001) (holding that a provision directing that any disputes proceed through arbitration was valid).

[FN85]. *Randolph v Green Tree Financial Corp*, 244 F3d 814, 818 (11th Cir 2001).

[FN86]. *Stone v Golden Wexler & Sarnese*, 341 F Supp 2d 189, 198 (ED NY 2004) (denying the defendant's motion to stay the proceedings on the plaintiff's allegations in favor of arbitration because the plaintiff never consented to the arbitration clause). A "change-in-terms" provision is a provision in the terms of a credit card agreement allowing the issuing bank to change the terms of the contract. See id at 192. See also *Discover Bank v Shea*, 362 NJ Super 200, 827 A2d 358, 366 (2001) (holding that the arbitration clause at issue was unconscionable by virtue of the unequal bargaining power evinced by both sides and the clear purpose of the provision to prevent litigation against the bank); *Badie v Bank of America*, 67 Cal App 4th 779, 79 Cal Rptr 2d 273, 287-88 (1998) ("[T]here is nothing about the original terms that would have alerted a customer to the possibility that the Bank might one day invoke the change of terms provision to add a clause that would allow it to *impose* ADR on the customer.").

[FN87]. See *Bank One v Coates*, 125 F Supp 2d 819, 831 (SD Miss 2001), affd 2002 US App LEXIS 7759 (5th Cir) ("Given, then, that the original cardholder agreement permitted amendments, the arbitration provision is not rendered unenforceable simply by virtue of the fact that Bank One undertook to add the arbitration provision via amendment."); *Stiles v Home Cable Concepts, Inc*, 994 F Supp 1410, 1418 (MD Ala 1998) (rejecting the plaintiff's request to invalidate an arbitration provision because the contract he signed allowed the defendant to change terms, the arbitration clause was not improper, and Alabama law authorizes such changes); *South Trust Bank v Williams*, 775 So 2d 184, 190-91 (Ala 2000) ("Amendments to the conditions of unilateral-contract relationships with notice of the changed conditions are not inconsistent with the general law of contracts. Federal law prohibits this Court from subjecting arbitration provisions to special scrutiny."); *Hutcherson v Sears Roebuck & Co*, 342 Ill App 3d 109, 793 NE 2d 886, 894 (2003) (finding that the addition of an arbitration provision was not unconscionable, because the agreement "contained a conspicuous paragraph, in capital letters, notifying card holders that they were relinquishing their rights to bring claims in court" and because card holders had the opportunity to "opt out of the amendments without causing their balances to become due").

[FN88]. It is perhaps instructive to contrast the deference given to states in allowing arbitration clauses to be more easily included in contracts, and the inability of the same states to force companies to highlight them more clearly to protect consumers. See *Doctor's Associates, Inc v Casarotto*, 517 US 681, 687 (1996) (holding that a

Montana law invalidating arbitration agreements was in direct conflict with the Federal Arbitration Act, and was thus preempted by federal law).

[FN89]. See 5 Del Code Ann § 952(a) (2001) (authorizing banks in Delaware to amend an agreement governing a revolving credit plan, so long as the agreement does not expressly forbid such changes). See also *Stone*, 341 F Supp 2d at 193 (noting that, although the addition of an arbitration provision has precedent in other jurisdictions, those cases often rely on explicit statutory authorization for such changes, authorization that Virginia lacks); Gilles, *Opting Out of Liability* at 30 (cited in note 81) (arguing that the number of class action lawsuits will dwindle in coming years because of contractual waiver agreements that instead submit disputes to arbitration).

[FN90]. See *Ingle v Circuit City Stores, Inc*, 328 F3d 1165, 1171-74 (9th Cir 2003) (finding that the parties' unequal bargaining power made the contract procedurally unconscionable, and the one-sided terms made it substantively unconscionable); *Ting v AT&T*, 319 F3d 1126, 1150 (9th Cir 2003) (finding the arbitration agreement to be unconscionable because it did not meet California's "bilaterality" requirement); *Acorn v Household International, Inc*, 211 F Supp 2d 1160, 1171 (ND Cal 2002) (rejecting the defendant's argument that "it could not be unconscionable to prohibit class-wide arbitration in an agreement whose substantive terms are governed by the [Federal Arbitration Act]"); *Discover Bank v Superior Court*, 36 Cal 4th 148, 30 Cal Rptr 3d 76, 87 (2005) (stating that when there are allegations that the party with superior bargaining power deliberately cheated many consumers out of "individually small sums of money," an arbitration provision effectively exempts that party "from responsibility for [its] own fraud, or willful injury to the person or property of another") (internal quotation marks omitted); *Dunlap v Berger*, 567 SE2d 265, 278-79 (W Va 2002) (finding that allowing a contract to "include a provision that prevents an aggrieved party from pursuing class action relief would go a long way toward allowing those who commit illegal activity to go unpunished, undeterred, and unaccountable"); *Szetela v Discover Bank*, 97 Cal App 4th 1096, 118 Cal Rptr 2d 862, 868 (2002) ("[S]uch a practice contradicts the California Legislature's stated policy of discouraging unfair and unlawful business practices, and of creating a mechanism for a representative to seek relief on behalf of the general public."); *Powertel, Inc v Bexley*, 743 S2d 570, 576 (Fla App 1999) ("[O]ne indicator of substantive unconscionability is that the agreement requires the customers to give up other legal remedies.").

[FN91]. See *Leonard v Terminix International Co*, 854 S2d 529, 535 (Ala 2002) (acknowledging that it is much easier for plaintiffs with small claims and little resources to obtain adequate counsel when the suit is brought as a class action). Gilles refers to the cost-spreading angle as being part of "second wave" challenges, which are more subtle than unconscionability challenges. "[C]reative plaintiffs' lawyers are arguing that the collective action waiver's implicit prohibition against cost-spreading across multiple claimants precludes plaintiffs from vindicating federal statutory rights in complex matters that would be expensive to litigate, at least where each plaintiff has relatively little at stake." Gilles, *Opting Out of Liability* at 5 (cited in note 81).

[FN92]. See Jack Wilson, *"No-Class-Action Arbitration Clauses," State-Law Unconscionability, and the Federal Arbitration Act: A Case for Federal Judicial Restraint and Congressional Action*, 23 Quinnipiac L Rev 737, 773 (2004) ("It thus seems likely that inconsistent results will persist, with outcomes possibly depending more on a particular judge's sympathies or understanding of the [Federal Arbitration Act] than on whether the plaintiffs' claims are economically viable in individual arbitration.").

[FN93]. This is particularly true in Delaware, whose law has wide-ranging effect. See *Edelist v MBNA America Bank*, 790 A2d 1249, 1261 (Del 2001) ("The surrender of that class action right was clearly articulated in the arbitration agreement."). See also *Pick v Discover Financial Services, Inc*, 2001 US Dist LEXIS 15777, *12-16 (D

Del) (finding that the plaintiff received adequate notice of the arbitration agreement).

[FN94]. See text accompanying notes 117-21.

[FN95]. See, for example, *Knepp v Credit Acceptance Corp*, 229 BR 821, 842 (ND Ala 1999) (recognizing that class action lawsuits are an efficient and effective mean by which consumers can obtain legal relief and refusing to bar these suits on account of arbitration clauses); *Powertel*, 743 S2d at 576 (holding that the arbitration clause at issue was unconscionable, in part because it forced the plaintiffs to "waive important statutory remedies" that they ought to be able to avail themselves of under Florida's Deceptive and Unfair Trade Practices Act). See also Jean R. Sternlight and Elizabeth J. Jensen, *Using Arbitration to Eliminate Consumer Class Actions: Efficient Business Practice or Unconscionable Abuse?*, 67 L & Contemp Probs 75, 82-83 (2004) (reviewing the West Virginia Supreme Court's decision in *Dunlap* and noting the significance that the court placed on the availability of class action relief as a realistic means of legal redress).

[FN96]. *Dunlap*, 567 SE2d at 278-79.

[FN97]. Id at 270.

[FN98]. See Dunham, 16 Franchise L J at 141 (cited in note 81) (arguing that most consumers will be very reluctant to take an individual claim where little money is at stake to arbitration). See also Alan S. Kaplinsky and Mark J. Levin, *Excuse Me, But Who's the Predator? Banks Can Use Arbitration Clauses as a Defense*, 7 Bus L Today 24, 26-28 (May/June 1998) (discussing recent case law that has led to an increase in arbitration clauses intended to defend against class action lawsuits). "Lenders that have not yet implemented arbitration programs should promptly consider doing so, since each day that passes brings with it the risk of additional multimillion-dollar class action lawsuits that might have been avoided had arbitration procedures been in place." Id at 28.

[FN99]. See, for example, *Castano v American Tobacco Co*, 84 F3d 734, 748 (5th Cir 1996) ("[The] most compelling rationale for finding superiority in a class action ... [is] the existence of a negative value suit."). Negative value claims are typically defined as those claims in which the costs of enforcement in an individual action would exceed the expected individual recovery. See also *Inter-Op Hip Prosthesis Liability Litigation*, 204 FRD 359, 377 (ND Ohio 2001) (granting class certification based in part on the existence of a negative value suit).

[FN100]. See *Eisen v Carlisle & Jacquelin*, 417 US 156, 161 (1974) ("[P]etitioner's individual stake in the damages award he seeks is only $70. No competent attorney would undertake this complex antitrust action to recover so inconsequential an amount. Economic reality dictates that petitioner's suit proceed as a class action or not at all."). See also *Amchem Products, Inc v Windsor*, 521 US 591, 617 (1997), quoting *Mace v Van Ru Credit Corp*, 109 F3d 338, 344 (7th Cir 1997):

> The policy at the very core of the class action mechanism is 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 someone's (usually an attorney's) labor.

[FN101]. 36 Cal 4th 148, 30 Cal Rptr 3d 76 (2005).

[FN102]. Id at 85-86.

[FN103]. See, for example, *Blaz v Belfer*, 368 F3d 501, 504-05 (5th Cir 2004) (finding that there was no substantive right, but rather only a procedural right, to the plaintiff's class action suit under the Securities Litigation Uniform Standards Act), cert denied 125 S Ct 97 (2004); *Johnson v West Suburban Bank*, 225 F3d 366, 369 (3d Cir 2000) (finding that a statutory right to class action is "merely a procedural one, arising under [FRCP 23], that can be waived by agreeing to an arbitration clause"); *Champ v Siegel Trading Co. Inc*, 55 F3d 269, 276 (7th Cir 1995) (describing the pursuit of a class action as a "procedural nicet[y]"); *Strand v US Bank National Association*, 693 NW2d 918, 926 (ND 2005) ("Merely restricting the availability of class action is not, by itself, a restriction on substantive remedies. The right to bring an action as a class action is purely a procedural right.").

[FN104]. *Discover Bank*, 30 Cal Rptr 3d at 86.

[FN105]. Id at 85-86.

[FN106]. See id at 95 (allowing the claim to proceed as a class-wide arbitration, because the two alternatives - not enforcing arbitration agreements and allowing companies to use arbitration agreements as a means to virtual immunity from class liability - were unacceptable). Some question whether the hybrid class actions provided in California are practical, given the large role the court must play and the fact that some of the problems in class actions (certification of the class, role of the class attorney, etc.) might be magnified in arbitration. See Lindsay R. Androski, Comment, *A Contested Merger: The Intersection of Class Actions and Mandatory Arbitration Clauses*, 2003 U Chi Legal F 631, 647-51 (arguing that class action suits and arbitration are too incompatible to be treated together, so the "only statutorily permissible solution is to interpret arbitration clauses to waive class actions").

[FN107]. See Burch, 31 Fla St U L Rev at 1024 (cited in note 67) (providing justifications for states to accept classwide arbitration instead of allowing companies to escape all forms of class relief). Only "California, Pennsylvania and South Carolina have explicitly accepted classwide arbitration as an effective method of dispute resolution." Id.

[FN108]. But see Gilles, *Opting Out of Liability* at 45 (cited in note 81) (reporting that the AAA and NAF have announced that they "will not allow [their] arbitrators to entertain class-wide arbitrations, except in the rare case that an arbitration provision is explicitly called for in the contract").

[FN109]. See Wilson, 23 Quinnipiac L Rev at 778-79 (cited in note 92) (suggesting that companies should also be fearful of classwide arbitration because of unclear standards for judicial review on an arbitrator's class certification decision and the possibility that class members will claim the decision is not binding on them).

[FN110]. Id at 779-80.

[FN111]. See id at 780 (discussing an arbitration clause used by Cingular Wireless that mandated that the parties "agree that no arbitrator has the authority to ... order consolidation or class arbitration") (internal citation and quotation marks omitted).

[FN112]. Punitive damages, statutory damages, or attorneys' fees are not usually awarded through arbitration, which when combined with the removal of the threat of a class action, weakens ex-post accountability. See Mark E. Budnitz, *Arbitration of Disputes Between Consumers and Financial Institutions: A Serious Threat to Consumer Protection*, 10 Ohio St J on Disp Resol 267, 285-86, 339 (1995) (discussing the differences between arbitration and judicial trials). See also Shelly Smith, *Mandatory Arbitration Clauses in Consumer Contracts: Consumer Protection and the Circumvention of the Judicial System*, 50 DePaul L Rev 1191, 1234 (2001) (noting that consumers lose traditional remedies in arbitration hearings such as "punitive damages, statutory damages, emotional damages, and awards of attorneys fees," which creates "a disincentive for large companies to reform abusive practices ... [and] for consumers to dispute the abusive practices").

[FN113]. *Mitsubishi Motors Corp v Soler Chrysler-Plymouth, Inc*, 473 US 614, 632 (1985) (finding unjustified the conclusion that contracts of adhesion should "militate against automatic forum determination by contract"). See also *Gilmer v Interstate/Johnson Lane Corp*, 500 US 20, 33 (1991) (discussing arbitration agreements in the context of labor relations and noting that "mere inequality in bargaining power, however, is not a sufficient reason to hold that arbitration agreements are never enforceable").

[FN114]. *Mitsubishi*, 473 US at 628.

[FN115]. Id at 637.

[FN116]. Demaine and Hensler, 67 Law & Contemp Probs at 74 (cited in note 78) (summarizing the results of an analysis of empirical data on arbitration clauses in a wide variety of consumer purchases). Other issues include repeat-player bias, discovery, deadlines, remedies and cost allocation. See Martin Malin, *Privatizing Justice- But By How Much? Questions* Gilmer *Did Not Answer*, 16 Ohio St J on Disp Resol 589, 592 (2001) (suggesting a systematic approach for dealing with mandatory arbitration clauses, and the due process issues that they raise).

[FN117]. *Johnson v Tele-Cash, Inc*, 82 F Supp 2d 264, 270 (D Del 1999), revd as *Johnson v West Suburban Bank*, 225 F3d 366, 374-75 (3d Cir 2000) (holding that TILA did not create a substantive right to a class action). See also *Jung v Association of American Medical Colleges*, 300 F Supp 2d 119, 154-56 (D DC 2004) (refusing the defendant's requests to compel arbitration for various antitrust claims, because arbitration would "undermine the purposes of the Sherman Act"); *Walker v Ryan's Family Steak Houses, Inc*, 289 F Supp 2d 916, 924-26 (MD Tenn 2003) ("The most compelling reason that the [Employment Dispute Services, Inc.] forum is fundamentally unable to provide an effective substitute for the judicial forum is that the EDSI both exercises control over the pool of potential arbitrators and relies on the favor of its employer-clients for its livelihood."), affd 400 F3d 370, 385 (6th Cir 2005) (holding that the employer's practice of selecting the arbitrator to be fundamentally unfair to the employee).

[FN118]. See *Lozada v Dale Baker Oldsmobile, Inc*, 91 F Supp 2d 1087, 1105 (WD Mich 2000) ("Under the Michigan Consumer Protection Act, the availability of class recovery is explicitly provided for and encouraged by statute ... [so] the arbitration agreement ... impermissibly waives a state statutory remedy."); *Eagle v Fred Martin Motor Co*, 157 Ohio App 3d 150, 809 NE2d 1161, 1183 (2004) (concluding that because the arbitration clause at issue precluded class actions, it "clearly invades the policy considerations of the [Consumer Sales Practices Act,] ... is injurious to the interests of the state, is against public policy, and accordingly cannot, and will not, be enforced"); *Powertel*, 743 S2d at 576-77 ("[A]n arbitration clause is not enforceable if it would defeat the remedial purpose of [Florida's Unlawful and Deceptive Trade Practices Act] upon which an action is based."). See also Androski, Comment, 2003 U Chi Legal F at 642 (cited in note 106) (summarizing the holdings of *Powertel* and *Lozada*).

[FN119]. But see Richard B. Cappalli, *Arbitration of Consumer Claims: The Sad Case of Two-Time Victim Terry Johnson or Where Have You Gone Learned Hand?*, 10 BU Pub Int L J 366, 400-01 (2001) (providing various explanations as to why the Third Circuit misinterpreted legislative history, such as that the panel lacked integral components of the record, that the panel simply ignored the history, or that it scanned the history "through the wrong looking glass").

[FN120]. 500 US 20 (1991).

[FN121]. Id at 32 (internal quotation marks omitted), quoting *Nicholson v CPC International Inc*, 877 F2d 221, 241 (3d Cir 1989) (Becker dissenting) (arguing that arbitrators still have the "power to fashion equitable relief," even if it is not in a class action setting).
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Mr. COHEN. Our second witness is Richard Frankel. Professor Frankel teaches at Drexel University School of Law; and his chief scholarly interests include consumer, administrative, and immigration law. He served as a teaching fellow and supervising attorney for the Georgetown University Law Center's Appellate Litigation Program. While there, he supervised students litigating before the

U.S. Court of Appeals for the D.C. Circuit, the Fourth and Ninth Circuits, as well as the Board of Immigration Appeals.

Professor Frankel's clinical interests include consumer law, appellate advocacy, landlord-tenant law, immigration law, public benefit civil rights and prisoners' rights. Previously, he was a Goldberg-Dietzler Fellow for Trial Lawyers for Public Justice in Washington, where he litigated class action consumer protection and civil rights cases.

Thank you, Professor Frankel. Will you begin your testimony.

TESTIMONY OF RICHARD H. FRANKEL, ESQ., DREXEL UNIVERSITY EARLE MACK SCHOOL OF LAW

Mr. FRANKEL. Honorable Members of the Committee, thank you for the opportunity to participate in this hearing.

As several of the Members of the Committee mentioned, there has been a lot of debate about empirical evidence, either for or against arbitration and about whether consumers fare better in arbitration than they do in court. But what I would like to focus on today are problems that exist—with arbitration that exist, the public consequences of giving up your right to a jury trial, problems that exist irrespective of the specific outcomes for the private parties in the process.

And, specifically, the closed nature of the arbitration process relative to court and the expansive reach of Federal preemption that prevent States from regulating arbitration clauses and the way that they are permitted to regulate any other contract mean that no matter who benefits from arbitration, the public, and society at large, will suffer.

In particular, arbitration prevents the law as a whole from developing, growing, and adequately keeping up with changing circumstances; and this is a particular problem in the credit card sector precisely because arbitration clauses are so universally used in that area. That essentially allows an entire area of consumer protection law to be removed from public scrutiny by the use of adhesion contracts' take-it-or-leave-it arbitration clauses.

Arbitration hearings, unlike judicial hearings, are private matters. Arbitrators have no obligation to provide a written decision explaining how they reached their decision or to provide reasons justifying that decision. In fact, arbitrators have an incentive to write as little as possible in order to insulate their decisions from being overturned by courts.

Arbitrator decisions do not create precedent. They're not binding on anyone, including the arbitrator, who is free to disregard his or her own earlier decisions in later cases. And some arbitration providers even require the parties to keep proceedings confidential. This prevents the law from taking shape in the way that it normally does.

Judicial opinions, public, written, well-reasoned decisions play a crucial role in adapting the law to changing circumstances. They give notice to parties. They explain the meaning of the law to the public. They make the legal system transparent to the public at large, and they promote deterrence by informing individuals of their rights and responsibilities under the law. Without written decisions that create this kind of precedent, the law stagnates and stays in a position essentially of suspended animation.

And this is true both not just for private law but for public law as well. Even statutes, important public statutes like Title VII, our Civil Rights Act, the Truth in Lending Act, all of these are essentially removed from an ability for courts to give precedent decisions explaining what those laws mean when they are removed and put in a system of private arbitration.

The Honorable Congressman Franks called for a need for more information, and I wholeheartedly agree. And I think one of the problems with arbitration is that it is so private that we don't get the kind of information that we need in order to make informed decisions, in order to know that our justice system is working, in order to inspire public confidence in the way things work. Many arbitration providers, the ones who hold data, won't even release the data that they have unless they are required to by State law.

Now, I think in all of these potential problems with arbitration are exacerbated by a lack of meaningful opportunity for review of arbitrator decisions. Closed proceedings might be a little less problematic if the public had confidence that they could be reviewed for error. But the Federal Arbitration Act prohibits that from taking place.

Review of arbitration decisions has been called by courts as one of the narrow forms of judicial review that exists; and courts have said even when arbitrators findings are wacky or silly, or based on evidence outside the record, or based on gross errors of law, those findings will not be overturned.

Given all of these things, how or why the public should have any confidence in a system that is closed from public view, that involves decisionmakers who don't have to explain how they reach a decision, and that makes those decisions immune from review is beyond me. Public confidence in any judicial system, arbitral or public system, is important in making it legitimate; and there is no reason for the public to have any confidence in the system.

Now, the last significant problem with arbitration that I would like to address is the inability of States to take action to try and protect their citizens from the abuses of arbitration. Congressman Issa talked about the hubris of why should Congress act to over turn 200 years of contract law. But the hubris really is the current preemptive reach of the Federal Arbitration Act which precludes State legislatures from democratically enacting legislation that protects their citizens from the worst abuses of arbitration clauses. All of those are preempted by the Federal Arbitration Act.

Thank you.

Mr. COHEN. Thank you, Professor.

[The prepared statement of Mr. Frankel follows:]

PREPARED STATEMENT OF RICHARD H. FRANKEL

Testimony of Professor Richard H. Frankel[1]
Associate Professor of Law
Drexel University Earle Mack School of Law

Hearing Before the Subcommittee on Commercial and Administrative Law of the House Judiciary Committee

Testimony Presented at the Hearing on: "The Federal Arbitration Act: Is the Credit Card Industry Using the Act to Slam Shut the Courthouse Door?"

May 5, 2009

[1] Mr. Frankel is an Associate Professor of Law at the Drexel University Earle Mack School of Law. He also is the co-author of *Consumer Arbitration Agreements: Enforceability and Other Topics* (NCLC, 5th ed. & Supp. 2008) and has spoken at various conferences on the subject of arbitration.

INTRODUCTION

Mr. Chairman, Congressman Franks, honorable members of the Committee, thank you for the opportunity to participate in this important hearing. The current system of binding, mandatory arbitration, while perhaps once motivated by an admirable desire to create a fair and efficient system of voluntary and consensual alternative dispute resolution, has exploded in recent years and expanded far beyond its original purposes. Pervasive use of mandatory arbitration provisions in consumer contracts has turned an "alternative" form of dispute resolution into the only form of dispute resolution for the millions of consumers who use credit cards, cellular phones, and other products.[2] Considering that arbitration clauses are ubiquitous throughout the credit card industry and that most credit card companies include arbitration clauses in standard-form, adhesive, "take it or leave it" contracts in which the consumer has no opportunity to negotiate specific terms, the current arbitration system cannot be classified as

[2] Today, all of the largest credit card companies in the U.S. have binding arbitration clauses, and it is very hard to find any credit card issuer that does not have such a clause. *See, e.g.*, Consumers Union, *Best and Worst Credit Cards*, Consumer Reports, Oct. 2007; Day to Day, *Marketplace Report: Credit Disputes Favor Companies* (NPR radio broadcast Sept. 28, 2007) (available at 2007 WLNR 19048094) ("[I]t's often hard to find a credit card that doesn't make arbitration mandatory."); Simone Baribeau, *Consumer Advocates Slam Credit-Card Arbitration*, CHRISTIAN SCI. MONITOR, July 16, 2007 ("[I]f you own a credit card, chances are you have a mandatory arbitration clause.").

The credit card industry and financial services sector are not alone in requiring consumers to give up their right to go to court. Arbitration clauses have been added to take-it-or-leave-it contracts for many other consumer goods and services, including cell phones, residential phone service, computers, insurance, car sales, rental cars, mortuary services, pest control, and securities broker services.

Mandatory arbitration is also growing rapidly as a requirement for patients to receive necessary medical services, and millions of Americans are required by their employers to submit all claims – wage and hour claims and civil rights claims among others – to binding arbitration. *See, e.g.*, *Garrett v. Circuit City Stores*, 449 F.3d 672 (5th Cir. 2006) (employer's arbitration clause required military reservist to arbitrate his claim that employer did not preserve his job when he was sent to Iraq).

voluntary in any meaningful sense. Many companies – and credit card companies in particular – have used binding, mandatory arbitration to opt-out of the public justice system and to replace it with a process that is closed to the public, insulated from any meaningful review, and unaccountable to the democratic process. The inevitable victims of this truncation of democratic principles are the individual consumers who are bound by these clauses.

Simply put, the current arbitration regime undermines many of the most basic democratic values underlying our system of government, and it is a regime that only Congress can correct. In addressing the effects of mandatory arbitration, this testimony will make the following points:

- Forced arbitration stunts the development of legal principles because arbitrators are not required to give written reasons for their decisions and because their decisions do not create binding law. The lack of reasoned, precedential decisionmaking also threatens to undermine any purported efficiency gains from arbitration because parties likely will end up re-litigating the same issue over and over instead of resolving that issue once and for all in a single, precedential judicial decision.
- The lack of meaningful review of arbitrators' decisions, judicial or otherwise, reduces public confidence in the fairness of mandatory arbitration. Arbitration decisions, except in a few narrowly-defined circumstances, are virtually immune from review, even where the arbitrators ignore the relevant law or the facts of the case.
- Only Congress can act to correct the deficiencies in the arbitral process. The Supreme Court's overly broad interpretation of the preemptive effect of the Federal Arbitration Act (FAA) precludes state legislatures from addressing arbitration and limits judicial authority to determine whether arbitration clauses are unfair or unenforceable.

- Although corporations tout forced arbitration as a fairer, cheaper, and more efficient alternative to litigation, their own behavior belies their position. When corporations fear that they may face substantial damages, such as in a class action lawsuit, they prefer the procedural protections and judicial review of the legal system to arbitration. This behavior suggests that such corporations do not use arbitration clauses because they view arbitration as a superior forum to litigation, but because they desire to keep consumer disputes from reaching any forum whatsoever, arbitral or otherwise.

I. Mandatory Arbitration and Undermines Public Confidence and Hinders the Development of the Law.

The closed, opaque nature of mandatory arbitration demonstrates how arbitration is inconsistent with democratic values of openness and accountability. Many fundamental aspects of the judicial system that we take for granted are absent from the arbitration process. First, our judicial system is open to the public whereas arbitration is not. In general, anyone is free to attend court hearings and trials, and court documents are part of the public record and available for public inspection. Judges not only resolve disputes, but they give written and oral reasons for their decisions that allow both litigants and the public to evaluate whether judges have acted fairly. An open judicial system prevents disputes from being resolved in secret, allows the public to act as a check against judicial abuse and misconduct, and inspires public confidence that the judicial system is fair.[3] A high level of openness is crucial, because the legitimacy of

[3] The Supreme Court has repeatedly emphasized the importance of permitting public access to trials and court proceedings. *See, e.g.*, Richmond Newspapers, Inc. v. Va., 448 U.S. 555, 572-73 (1980) ("[W]here the trial has been concealed from public view an unexpected outcome can cause a reaction that the system at best has failed and at worst has been corrupted. . . . People in an open society do not demand infallibility from their institutions, but it is difficult for them to accept what they are prohibited from observing."); Sheppard v. Maxwell, 384 U.S. 333, 349

any binding dispute resolution tribunal ultimately rests on the acceptance of that tribunal by the public.[4]

Arbitration, by contrast, is a purely private process that gives little reason to inspire public trust and confidence.[5] Arbitration hearings are not open to the public. Arbitrators need not, and often do not, provide written decisions explaining why they reached a particular result.[6] Moreover, "unlike a judge, an arbitrator is neither publicly chosen nor publicly accountable."[7] Some arbitration providers even add an extra layer of secrecy by requiring parties to a dispute to keep the proceedings confidential.[8] Arbitration providers also have resisted publicly disclosing information statistics regarding their arbitrators' decisions, making disclosures only where state law requires them to do so.

This lack of transparency has significant consequences. Closed proceedings, arbitrator-mandated secrecy, and an absence of written decisions prevent both the public as well as arbitration participants from monitoring the fairness of the arbitration process, and from holding arbitrators' accountable for their decisions. Shielding the arbitration process from exposure and

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(1966) ("The principle that justice cannot survive behind walls of silence has long been reflected in the Anglo-American distrust for secret trials.").

[4] "It is the confidence in the men and women who administer the judicial system that is the true backbone of the law." Bush v. Gore, 531 U.S. 98, 128 (2000) (Stevens, J., dissenting).

[5] *See generally*, Richard C. Reuben, *Democracy and Dispute Resolution: The Problem of Arbitration*, 67 LAW & CONTEMP. PROBS. 279, 298-302 (2004).

[6] *See* United Steelworkers of Am. v. Enter. Wheel & Car Corp., 363 U.S. 593, 598 (1960); Paul D. Carrington & Paul H. Haagen, *Contract and Jurisdiction*, 1996 SUP. CT. REV. 331, 397-98.

[7] Cole v. Burns Int'l Sec. Servs., 105 F.3d 1465, 1476 (D.C. Cir. 1997).

[8] *See, e.g.*, Am. Arbitration Ass'n, Employment Arbitration Rules & Procedures, Rule 23, *available at* www.adr.org/sp.asp?id=28481; JAMS Streamlined Arbitration Rules & Procedures Rule 23; National Arbitration Forum Code of Procedure Rule 4.

scrutiny signals to the public that arbitrators have little concern for the law that they ostensibly apply and that arbitrators are motivated more by results than by fairness. Eliminating any requirement that arbitrators justify their decisions by providing written reasons sends the message that even the arbitrator may not have full confidence that his or her decision is correct. Even if arbitrators do not actually proceed in such a results-oriented fashion, as long as the public is given reason to believe that they do, public confidence in arbitration as a fair dispute resolution system will be badly damaged.

In addition to diminishing public confidence in a fair and impartial justice system, mandatory arbitration also hinders the development of the law. The law grows and evolves in large part through written, reasoned judicial decisions that explain, clarify, and expound on legal principles. Since *Marbury v. Madison* was decided more than 200 years ago, it has been the role of the judiciary to "say what the law is."[9] Our courts operate in a common-law tradition in which legal principles evolve as judges adapt and interpret the law to meet new situations and changing practices. But judges do more than just build common-law. They also engage in a dynamic relationship with legislative bodies by interpreting ambiguous statutes, by issuing public decisions that signal to lawmakers when legislative reform might be warranted, and by grappling with difficult questions that legislatures may specifically leave for courts to decide. Moreover, judicial decisions communicate important values not only to judges and lawmakers, but also to the public. Specifically, written decisions and public hearings "educate the public and potential wrongdoers about how the law is being interpreted, thereby deterring potential wrongdoers from violating the law, educating victims as to their rights, and inviting the public to

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[9] Marbury v. Madison, 5 U.S. (1 Cranch) 137, 177 (1803).

take action to help reform the law should it not be satisfied with the public results."[10] Each of these important functions, however, depends on judges issuing written, precedential decisions that explain the law and provide rules to govern future disputes.

Arbitration shares none of these characteristics and therefore threatens to stagnate the development of legal principles. Not only do arbitrators have no obligation to provide reasoned decisions, their decisions, written or otherwise, have no binding effect on courts, other arbitrators, or even themselves.[11] The result is that the law does not grow, no guidance is provided to other courts, arbitrators, or litigants, and legislatures remain in the dark as to whether their enactments are being interpreted correctly or are effectively addressing the problems they intended to address. Arbitration also makes it much more difficult for either legislatures or the public to learn of, and respond to, corporate wrongdoing. Arbitration decisions, especially when they remain private, will not exert the same deterrent effect as public, binding judicial decisions. In other words, arbitration stifles not just the common-law process, but the legislative process as well.

Such a result is regrettable enough when limited to disputes involving private law, but arbitration clauses are now written so broadly as to also sweep in important public rights, such as rights against employment discrimination and consumer fraud. As the Chief Justice of the Texas Supreme Court, Wallace Jefferson, recently stated, "A privately litigated matter may well affect public rights. . . . Its resolution may ultimately harm the public good or, because those decisions

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[10] Jean R. Sternlight, *Creeping Mandatory Arbitration: Is it Just?*, 57 STAN. L REV. 1631, 1662 (2005).

[11] *See, e.g.*, IDS Life Ins. Co. v. SunAmerica Life Ins. Co., 136 F.3d 537, 543 (7th Cir. 1998) ("[A]rbitrators' decisions are not intended to have precedential effect even in arbitration (unless given that effect by contract), let alone in the courts.").

are secret, impede innovation to a recurring problem, much to the detriment of Texas citizens."[12] Given the near-universal presence of arbitration clauses in credit card and other consumer contracts, forced arbitration removes entire areas of consumer protection law from the judicial system and thus prevents the law from evolving to keep up with new and changing predatory and illegal practices.

Finally, because arbitration decisions are not precedential, moving cases out of court and into arbitration undermines any purported efficiency gains from the arbitration process. One of the advantages of a hierarchical judicial system that creates binding precedent is predictability – a single decision can define a legal rule that governs all lower courts within that jurisdiction. Clear decisions setting out legal rules will help future parties conform their behavior to the law and will reduce future lawsuits because parties will have know what the law permits and forbids. Arbitration, by contrast, may lead to re-litigation of the same issue over and over because (a) parties will have little guidance regarding their rights and responsibilities, and (b) even if they do, they know that arbitrators are not required to rigidly apply the law and are perfectly free to reach different results in similar cases. Moreover, arbitration undermines efficiency because the closed nature of each individual proceeding requires attorneys to engage in duplicative discovery practices and prevents attorneys from sharing evidence across individual cases. This not only leads to wasteful repetition, it also disproportionately harms consumers, who often do not have the same access to information as corporate defendants.[13]

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[12] Mike Ward, *Texas' Chief Justice Calls for Overhaul of Courts*, AUSTIN AMERICAN-STATESMAN, Feb. 21, 2007.

[13] *See, e.g.*, Jean R. Sternlight, *Panacea or Corporate Tool?: Debunking the Supreme Court's Preference for Binding Arbitration*, 74 WASH. U. L.Q. 637, 683-84 (1996) ("[A] consumer's attorney often relies on public information gained from other lawsuits to build her own claims of negligent or intentional misconduct. Repeat-player companies can gain similar information

II. Arbitration Undermines Democratic Values By Insulating Arbitrator's Decisions From Meaningful Review.

Another hallmark of our judicial system is that it creates accountability through the process of judicial review. The judicial system protects against arbitrary decisionmaking by giving litigants an opportunity to seek review of an initial decision, usually to a panel of three judges. Meaningful review is such an important value that virtually every state as well as the federal government provides for an appeal as a matter of right, and for criminal defendants, the Constitution guarantees the right to be represented on appeal by competent counsel.[14]

Judicial review of arbitrators' decisions, however, is not "review" in any meaningful sense. Rather it is "very narrow; one of the narrowest standards of judicial review in all of American jurisprudence." *Lattimer-Stevens Co. v. United Steelworkers of Am. Dis. 27*, 913 F.2d 1166, 1169 (6th Cir. 1990).[15] Consider the following examples:

- The U.S. Court of Appeals for the Seventh Circuit remarked that courts should not review arbitrators' interpretations of contracts even if they are "wacky," so long as the arbitrator

through private channels. Thus, by requiring private arbitration the company may again deprive the consumer of certain relief she might have obtained through litigation." (citations omitted)).

[14] Douglas v. People of the State of Cal., 372 U.S. 353 (1963).

[15] *See also* First Options of Chicago, Inc. v. Kaplan, 514 U.S. 938, 942 (1995) ("the court will set aside [an arbitrator's] decision only in very unusual circumstances."); Baravati v. Josephthal, Lyon & Ross, 28 F.3d 704, 706 (7th Cir. 1994) ("Judicial review of arbitration awards is tightly limited."); *IDS Life Ins. Co.*, 136 F.3d at 543 ("[J]udges follow the law . . ., while arbitrators, who often . . . are not lawyers and cannot be compelled to follow the law and their errors cannot be corrected on appeal (there are no appeals in arbitration), although there are some limitations on the power of arbitrators to flout the law."); Di Russa v. Dean Witter Reynolds Inc., 121 F.3d 818, 821 (2d Cir. 1997) (to modify or vacate an arbitration award, a court must find both that (1) the arbitrators knew of a governing legal principle yet refused to apply it or ignored it altogether, and (2) the law ignored by the arbitrators was well defined, explicit, and clearly applicable to the case).

attempted to "interpret the contract at all." *See Wise v. Wachovia Securities, Inc.*, 450 F.3d 265, 269 (7th Cir. 2006).

- The U.S. Court of Appeals for the Third Circuit considered an arbitrator's decision that "inexplicably" cited and relied upon language that was not included in a key document. The court held that "such a mistake, while glaring, does not fatally taint the balance of the arbitrator's decision in this case. . . ." *Brentwood Medical Associates v. United Mine Workers of America*, 396 F.3d 237 (3d Cir. 2005).
- In a case involving baseball player Steve Garvey, the U.S. Supreme Court held that "courts are not authorized to review the arbitrator's decision on the merits" even if the arbitrator's fact finding was "silly." *Major League Baseball Players Ass'n v. Garvey*, 532 U.S. 504, 509 (2002).
- The California Supreme Court has held that even when an arbitrator's decision would "cause substantial injustice," it was not subject to judicial review. *Moncharsh v. Heily & Blase*, 3 Cal. 4th 1 (1992).
- The U.S. Court of Appeals for the Eleventh Circuit stated that parties who challenge arbitration awards should be sanctioned more often for asking for judicial review, and that this would be "an idea worth considering" in order to discourage future challenges to arbitration. *B.L. Harbert International, LLC v. Hercules Steel Co.*, 441 F.3d 905 (11th Cir. 2006).

Moreover, the current trend favors restricting judicial review even further. Some federal courts of appeals have interpreted the U.S. Supreme Court's recent decision in *Hall Street*

Associates v. Mattel, 128 S. Ct. 1396 (2008), as eliminating a court's ability to vacate an arbitrator's decision, even when the arbitrator acts in "manifest disregard" of the law.[16]

The lack of meaningful review is dangerous on several fronts. First, it merely reinforces the perception that arbitration is a private system of justice that is unaccountable either to the public or to any branch of government. Second, it reduces transparency by further discouraging arbitrators from providing reasoned decisions, because without any reasoning, there is no basis for a party to attack those decisions.[17] Third, and perhaps most importantly, the lack of review may discourage individuals injured by corporate misconduct from initiating an arbitration in the first place. The fear of having to pay opposing parties' attorneys' fees and costs if they lose without any opportunity to effectively appeal the decision may make arbitration too risky a proposition for most consumers.[18] In sum, the lack of meaningful review exacerbates some of mandatory arbitration's most fundamental shortcomings.

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[16] *See* Citigroup Global Mkts, Inc. v. Bacon, __F.3d__, 2009 WL 542780 (5th Cir. Mar. 5, 2009) (holding that "manifest disregard of the law is no longer an independent ground for vacating arbitration awards"); Ramos-Santiago v. United Parcel Serv., 524 F.3d 120, 124 n.3 (1st Cir. 2008) (same). *But see* Comedy Club inc. v. Improv West Assocs., 553 F.3d 1277, 1290 (9th Cir. 2009); Stolt-Nielsen SA v. AnimalFeeds Int'l Corp., 548 F.3d 85, 83-85 (2d Cir. 2008); Coffee Beanery, Ltd. v. WW, L.L.C., 300 Fed Appx. 415, 418-19 (6th Cir. 2008).

[17] *See, e.g.*, Fellus v. AB Whatley, Inc., 2005 WL 9756090 (N.Y. Sup. Ct. Apr. 15, 2005) (in the absence of a reasoned decision supporting an arbitration award, there was no basis for court to decide whether arbitrator manifestly disregarded the law); H&S Homes v. McDonald, 2004 WL 291491 (Ala. Dec.17, 2004) (in the absence of an explanation of damages awarded by arbitrator, court had no basis to determine whether arbitrator manifestly disregarded the law).

[18] *See Mandatory Binding Arbitration Agreements: Are They Fair to Consumers?: Hearing Before the Subcomm. on Commercial and Administrative Law of the H. Comm. on the Judiciary*, 110th Cong. (June 12, 2007) (Statement of Professor David S. Schwartz).

III. Only Congress Can Reform the Arbitration System Because of the Federal Arbitration Act's Sweeping and Overbroad Preemptive Reach.

Regardless of what is the best solution for the problems posed by the current arbitration system, only Congress can provide that solution. Whereas with other legislative initiatives, Congress can decide not to act in order to allow individual states to first experiment with different reforms, that option is unavailable here because the Supreme Court has adopted an expansive, and in my view, misguided interpretation of FAA preemption that bars States from attempting to regulate or reform the arbitration process in any effective way. The current doctrine of FAA preemption is entirely judge-made and lacks any basis in the FAA's text, as the statute itself contains no preemption provision. Consequently, former Supreme Court Justice Sandra Day O'Connor has explained that "the Court has abandoned all pretense of ascertaining congressional intent with respect to the Federal Arbitration Act, building instead, case by case, an edifice of its own creation."[19] The current doctrine not only gives arbitration agreements a specially-protected status, but it also has turned the field of arbitration regulation into a one-way street: states are permitted to adopt legislation that promotes arbitration, but are prohibited from adopting legislation that constrains or regulates arbitration.

The Supreme Court has stated that the FAA was enacted with the original purpose of overcoming judicial refusal to enforce valid, fair arbitration agreements because courts did not want to give up their own jurisdiction.[20] In that respect, the Act simply intended to make

[19] Allied-Bruce Terminix Cos., Inc. v. Dobson, 513 U.S. 265, 283 (1995) (O'Connor, J., concurring); *see also* Perry v. Thomas, 482 U.S. 483, 493 (1987) (Stevens, J., dissenting) ("It is only in the last few years that the Court has effectively rewritten the statute to give it a pre-emptive scope that Congress certainly did not intend.").

[20] *See Dobson*, 513 U.S. at 270.

arbitration agreements "as enforceable as other contracts, but not more so."[21] Moreover, the text of the FAA expressly preserves state law by declaring that arbitration agreements may be unenforceable "on such grounds as exist in law or equity for the revocation of any contract."[22] Thus, to the extent that the FAA should preempt state law at all,[23] its preemptive effect should be very narrow in scope.

Supreme Court decisions over the last 20-25 years, however, have wildly expanded FAA preemption, invalidating all sorts of state laws. One law professor's sample of court decisions from January 2002 to April 2004 found almost fifty state laws that were declared preempted by courts.[24] Courts have interpreted the FAA as preempting almost any law that has the effect of making arbitration agreements more difficult to enforce. Even laws that do not attempt to make arbitration clauses automatically unenforceable may be preempted. For example the Supreme Court invalidated a Montana law that did not prohibit arbitration but simply required contracts containing arbitration clauses to include a notice regarding the arbitration clause on the front page of the contract.[25]

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[21] Prima Paint Corp. v. Flood & Conklin Mfg. Co., 388 U.S. 395, 404 n.12 (1967).

[22] Federal Arbitration Act, 9 U.S.C. § 2.

[23] A number of scholars and judges have made a persuasive case that the Congress intended the FAA only to apply procedural rules to federal courts, and did not intend for the FAA to create federal substantive law that was binding on the States. *See, e.g.*, *Allied-Bruce*, 513 U.S. at 285-95 (Thomas, J., dissenting); Southland Corp. v. Keating, 465 U.S. 1, 22-31 (O'Connor, J., dissenting); David S. Schwartz, *The Federal Arbitration Act and the Power of Congress over State Courts* 83 ORE. L. REV. 541, 542 & n.7 (2004).

[24] David S. Schwartz, *State Judges as Guardians of Federalism: Resisting The Federal Arbitration Act's Encroachment On State Law*, 16 WASH. U. J. L. & POL'Y 129, 154-59 (2004).

[25] *See* Doctor's Assocs., Inc. v. Casarotto, 517 U.S. 681 (1996).

The Court's current preemption doctrine has caused several adverse consequences. First, it violates basic constitutional principles of federalism. The FAA, as currently interpreted, deprives States of their traditional authority to regulate contracts and to protect the health, safety, and welfare of their citizens. If Congress wishes to deprive States of the authority to protect consumers by regulating forced arbitration, then it may do so. But it should not allow state sovereignty to be so easily circumvented by Supreme Court decisions untethered to the text and intent of the FAA in the absence of clear congressional will.

Second, the current preemption doctrine undermines the democratic process by thwarting the will of democratically-elected state legislatures. Although Congress, in enacting the FAA, was concerned about *judicial* hostility to arbitration agreements, the Court has interpreted the statute to override validly-enacted state *legislation*. It is one thing to say that judges should not be permitted to subvert the democratic process by ignoring state law and state-law contract principles in refusing to enforce arbitration agreements out of a desire to protect their own jurisdiction. It is another to say that state legislatures lack the authority to represent their citizens by passing laws that seek to curb some of the worst abuses of the arbitration system. Current preemption doctrine therefore turns the FAA on its head by short-circuiting the democratic process and by stripping state legislatures of the ability carry out the will of their constituents.

Third, rather than placing arbitration agreements "upon the same footing as other contracts,"[26] FAA preemption has transformed arbitration agreements into super-contracts that are immune from and often override state contract and consumer protection law. Courts have held that state laws and certain state contract doctrines that apply to other contracts cannot be

[26] Volt Information Sciences, Inc. v. Bd. of Trustees of Leland Stanford Junior Univ., 489 U.S. 468, 474 (1989).

applied to arbitration clauses. Courts have held that even if every other provision in a contract is void because the contract is illegal, the contract's arbitration clause is still enforceable.[27]

Fourth, FAA preemption distorts the playing field by permitting legislation that favors arbitration while forbidding legislation that seeks to constrain or regulate arbitration. States are perfectly free to pass laws that expand the scope of arbitration. The FAA therefore places companies that favor arbitration in a great position because arbitration-related legislation can proceed in only one direction. Any "pro-arbitration" legislation that corporate arbitration defenders are able to push through state legislatures are fully enforceable while any efforts to place limits on arbitration or to regulate the most abusive arbitration practices risk preemption. Indeed, corporations have taken advantage of this inequality to push through state legislation condoning some of the most dangerous aspects of arbitration clauses. For example, Utah enacted a statute that expressly permits contracting parties to waive their right to participate in a class action, while state legislation forbidding a waiver of the right to bring a class action has been declared preempted when applied to an arbitration clause.[28]

It is important for Congress to act because, given the expansive and unwise reach of FAA preemption, no other body is capable of doing so. Preemption not only restricts the ability of state legislatures to correct problems with arbitration, it also restricts the authority of courts to protect consumers against unsavory arbitration provisions. Although courts certainly have

[27] *See, e.g.*, Buckeye Check Cashing, Inc. v. Cardegna, 546 U.S. 440 (2006) (holding that the arbitrator must determine whether a contract containing an arbitration provision is illegal and void).

[28] *Compare* Utah Code Ann. § 70C-4-105 (permitting enforcement of class action waivers in creditor-debtor contracts), *with* Ting v. AT&T, 319 F.3d 1126, 1147-48 (9th Cir. 2003) (finding the California Consumer Legal Remedies Act preempted because it was not "a law of general applicability").

declared arbitration clauses unenforceable, the Supreme Court has held that some types of challenges to the enforceability of contracts containing arbitration clauses must be decided by an arbitrator rather than by a court.[29]

Nor is there any reason for Congress to delay in taking action. The original justification for the FAA, overcoming judicial hostility to arbitration clauses, does not reflect current realities. If anything, judges with crowded dockets have an incentive to favor enforcement of mandatory arbitration clauses as a way of managing an overly-burdensome caseload. Moreover, waiting to act only provides additional opportunity for courts to further expand FAA preemption. For example, one strategy being undertaken by corporate defendants is to argue that any law which invalidates any portion of an arbitration clause is preempted because the FAA creates a substantive right to enforcement of an arbitration clause "in the manner provided for" in the clause.[30] Although the Supreme Court has not yet adopted this interpretation of the FAA, the dangers of such a view are evident. Creating a substantive right to enforce arbitration agreements exactly as written would give an incentive for companies to put in as many one-sided arbitration provisions as possible, since they would know that the FAA would insulate those provisions from any challenge.

IV. Corporations' Own Behavior Indicates that They do not Believe that Arbitration is a Fair and Efficient Alternative to Litigation.

Notwithstanding the above-described shortcomings of the arbitration system, corporations defend mandatory arbitration by asserting that it is a faster, cheaper, and fairer

[29] *See, e.g.*, *Cardegna*, 546 U.S. 440 (holding than an arbitrator, rather than a court, must decide if loan contract with a triple-digit interest rate is illegal and void).

[30] *See, e.g.*, Muhammad v. County Bank, No. 06-907, Petition for Writ of Certiorari (Jan. 3, 2007) at 18-21; *see also* Schwartz, *supra* note 23, at 563-68 (describing this trend).

alternative to judicial dispute resolution and therefore should be encouraged, irrespective of any ensuing sacrifice of democratic principles. Given the prevalence of mandatory arbitration clauses in the consumer setting, I wish this assertion was true. However, I remain unconvinced, for several reasons. Initially, it is noteworthy that the only groups touting the benefits of forced arbitration for consumers are those that seek to impose arbitration *against* consumers. No reputable consumer advocacy organizations of which I am aware endorse widespread use of pre-dispute mandatory arbitration provisions. I am hard-pressed to think of another circumstance in which a group's *adversaries* are allowed to decide what is beneficial for that particular group.

More importantly, however, corporations' own behavior concerning arbitration belies their statements that forced arbitration is a superior alternative to the courts. For example, several recent studies show when it comes to business-to-business contracts that are negotiated at arm's-length, companies are much more reluctant to include arbitration provisions than they are in their contracts with consumers.[31] That negotiated contracts typically omit arbitration agreements and that arbitration agreements are most pervasive when imposed through adhesion contracts itself is telling about how fair such provisions truly are.[32] In fact, many of the same

[31] *See* Theodore Eisenberg, Geoffrey P. Miller & Emily L. Sherwin, *Arbitration's Summer Soldiers: An Empirical Study of Arbitration Clauses in Consumer and Nonconsumer Contracts*, 41 U. MICH. J.L. REFORM 871 (2008) (conducting study showing that more than 75% of company contracts with consumers required arbitration whereas fewer than 10% of nonemployment, nonconsumer contracts contained arbitration clauses); Theodore Eisenberg & Geoffrey P. Miller, *The Flight from Arbitration: An Empirical Study of Ex Ante Arbitration Clauses in Publicly-Held Companies*, 56 DEPAUL L. REV. 335 (2007) (finding that only 11% of surveyed companies used arbitration clauses in their contracts with other companies).

[32] Theodore Eisenberg, Geoffrey P. Miller & Emily L. Sherwin, *Arbitration's Summer Soldiers: An Empirical Study of Arbitration Clauses in Consumer and Nonconsumer Contracts*, 41 U. MICH. J.L. REFORM 871, 876 (2008) ("The systematic eschewing of arbitration clauses in business-to-business contracts also casts doubt on the corporations' asserted beliefs in the superior fairness and efficiency of arbitration.").

business groups that support forced arbitration when imposed on consumers have opposed the Employee Free Choice Act precisely because it would require binding arbitration between a union and a business if the two fail to come to a labor agreement within a certain period of time.[33] Similarly, many car dealers have inserted binding arbitration clauses into their car sales contracts, although those same car dealers lobbied for and won a federal statute that bars car manufacturers from insisting that dealers arbitrate disputes. In the process of lobbying for that statute, auto dealers specifically decried how arbitrators were not required to follow the law, and how arbitration actually had greater out-of-pocket expenses than litigation.[34] If companies truly believe that forced arbitration is a superior system, then they would put their money where their mouth is. To date, they have not.

In my view, one of the most telling examples of how corporations do not actually believe that forced arbitration is a fair and trustworthy system concerns how they deal with the prospect of class actions. Most arbitration provisions in consumer contracts bar the consumer from participating in class actions.[35] The dangers of class-action bans in arbitration clauses are well-documented.[36] Because many instances of consumer fraud involve relatively small-dollar injuries, many cases will never be brought if they can proceed only on an individual basis. Class

[33] *See, e.g.*, U.S. Chamber of Commerce, Employee Free Choice Act – The "Card Check" Bill, *available at* http://www.uschamber.com/issues/index/labor/cardchecksecrbal.htm.

[34] *See* Public Citizen, *Auto Dealers and Consumers Agree: Mandatory Arbitration Is Unfair*, available at http://www.citizen.org/congress/civjus/arbitration/ articles.cfm?ID=650.

[35] One recent empirical study of arbitration agreements revealed that in its sample, "every consumer contract with an arbitration clause also included a waiver of classwide arbitration." Eisenberg, et al., *supra* note 32, at 884.

[36] *See, e.g.*, Jean R. Sternlight, *As Mandatory Binding Arbitration Meets the Class Action, Will the Class Action Survive?*, 42 WM. & MARY L. REV. 1 (2000).

actions are specifically designed to deal with the circumstance where "small recoveries do not provide the incentive for any individual to bring a sole action."[37] Barring individuals from bringing class actions, either in arbitration or in litigation, effectively immunizes corporate wrongdoers for certain classes of illegal conduct that cause small-dollar injuries but that affect thousands or millions of individuals.

Despite these concerns, corporations defend class-action bans by arguing that class action litigation is so expensive that arbitration is still a superior alternative. However, while companies apparently have no problem telling consumers that arbitration is a superior alternative when class action bans are in place, they tend to take the opposite view when class-action bans are threatened. A majority of consumer arbitration now state that if the class action ban is declared unenforceable, then the whole arbitration clause is unenforceable.[38] The existence of such exploding arbitration provisions is unsurprising. After all, once corporations face the prospect of a large potential class action judgment, then the limited judicial review and limited procedural protections that corporations champion as necessary for making mandatory arbitration faster and more streamlined no longer are acceptable to them. The use of such arbitration provisions suggests that companies do not necessarily see arbitration as a superior forum to litigation, but that they mandatory contractual arbitration provisions – and class action bans in particular – as a way of keeping consumers out of any forum, either arbitration or litigation.

In my view, any argument that a class action ban promotes cost savings ineluctably rests on the assumption that consumers will not bring individual arbitrations in place of a class action.

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[37] Amchem Prods., Inc. v. Windsor, 521 U.S. 591, 617 (1997).

[38] *See* Eisenberg, et al., *supra* note 32, at 884 (conducting study finding that 60% of consumer contracts had a provision declaring the whole arbitration clause unenforceable in the event that the class action ban was unenforceable).

Having thousands of separate individualized arbitrations in front of separate arbitrators in which the same documents would be submitted in separate hearings undoubtedly would be more cumbersome, expensive and wasteful than consolidating all of those claims into a single action. As Congress has recognized, the class action mechanism promotes efficiency by aggregating similar claims into a single lawsuit, thereby avoiding the repetition and expense of separate actions for each harmed individual: "Class action lawsuits are an important and valuable part of the legal system when they permit the fair and efficient resolution of legitimate claims of numerous parties by allowing the claims to be aggregated into a single action against a defendant that has allegedly caused harm."[39] Thus, corporations' own behavior regarding their arbitration clauses suggests that their true interest is not arbitration, but immunity.

CONCLUSION

The current arbitration system is one that no longer resembles what Congress originally envisioned in passing the Federal Arbitration Act. The private nature of arbitration sacrifices democratic values of openness and accountability. Mandatory arbitration also subverts the democratic process by broadly preempting validly-enacted state statutes relating to arbitration. Because the States and the courts cannot adequately protect consumers from the dangers of arbitration, it is up to Congress to act. I thank the Committee for allowing me to testify today and I hope that the Committee considers reforming the arbitration system to provide consumers with the protections they deserve.

[39] Class Action Fairness Act of 2005, 28 U.S.C. § 1711 (2005).

Mr. COHEN. Our third witness is Christopher Drahozal. Professor Drahozal teaches at the University of Kansas, which Memphis gave a national championship to 2 years ago, and is an internationally known scholar whose writing focuses on the law and economics of dispute resolution, particularly arbitration. He is the author of multiple books and numerous articles on commercial arbitration and has taught and given presentations on the subject in Europe and the USA, serving as associate reporter for the ALI's restatement of the U.S. law of international commercial arbitration.

Prior to coming to Kansas, the professor practiced law with Sidley and Austin in D.C. and served as a law clerk for Justice Byron R. White of the United States Supreme Court and Judge George H. Aldrich of the Iran-United States Claims Tribunal in The Hague, the Netherlands.

Thank you, Professor Drahozal. Will you please proceed with your testimony.

TESTIMONY OF CHRISTOPHER R. DRAHOZAL, ESQ., UNIVERSITY OF KANSAS SCHOOL OF LAW

Mr. DRAHOZAL. Thank you.

Chairman Cohen, Ranking Member Franks, Members of the Subcommittee, I really appreciate the opportunity to be here today. I did not wear my Jayhawk tie in deference.

I have been very pleased with the discussion so far with sort of interest in empirical work. Because, from my perspective, I think sound empirical evidence is really essential for making good public policy. In the arbitration area, actually, one commentator recently found "a consensus that the future of arbitration should be decided by data, not anecdote."

The Searle study, which I am the Chair of the Consumer Arbitration Task Force of the Searle Civil Justice Institute, is the most recent and, frankly, the most comprehensive look at consumer arbitration as here administered by the American Arbitration Association. A few sort of background points on the Searle study.

First of all, there is absolutely no industry funding whatsoever for the study. It was funded exclusively by the initial grant of money to set up the Searle Center to Northwestern Law School by the late Daniel Searle, a Northwestern trustee. I would frankly have made a condition of my participation in the study that they not use industry money, and that was never an issue because that was never the plan. So no industry funding whatsoever for the study.

Searle Civil Justice Institute follows a rigorous research protocol governing how we do our work. The report itself, as was mentioned previously, was peer reviewed by an array of scholars on arbitration law and empirical work on arbitration law and, frankly, from across the ideological perspective, from supporters and critics of consumer arbitration.

We are very comfortable with the methodology of the study. Obviously, our results focusing on the American Arbitration Association are limited to the AAA, as we made clear in the report. Nonetheless, in deciding national policy on arbitration, it seems to me that what is done by the oldest and most prominent arbitration association in the country certainly is relevant to that debate.

Our study did not focus exclusively on credit card disputes but certainly includes a significant number of credit card disputes and, more broadly, debt collection disputes in our sample.

A couple of highlights from the study, and there is a lengthy study, plenty to say, but I will just make a couple of points at this stage.

First, the vast majority of the arbitrations in that study arose out of pre-dispute clauses, over 96 percent. Only a handful of cases arose out of post-dispute clauses. That result is actually consistent with every other study that I have seen looking at employment arbitration.

And, interestingly, international arbitration is the same way. The vast majority of disputes arise out of pre-dispute clauses.

The standard advice in drafting—and the reason I mention international arbitration is there is no question there that you have sophisticated parties on both sides, no concerns about the fairness of the process; and yet, even in that setting, if you don't have a pre-dispute clause, you don't end up with arbitration.

The implications of sort of the finding in a consumer setting and in the international setting to me are, first, that if you get rid of pre-dispute clauses, it is essentially going to get rid of consumer arbitration; and, second, the reason is not because of some unfairness in the consumer arbitration process, because that rationale wouldn't apply in the international arbitration process. The reason is because, once a dispute arises, parties' interests and perspectives change; and once you have a dispute, somebody's going to benefit from going to court, somebody's not. And at that point they can't reach an agreement. No reflection on the unfairness of the arbitration process, but allowing a pre-dispute clause enables parties to enter into agreements that make them both better off they otherwise couldn't enter into.

Second highlight and my final minute of my opening statement is we have a variety of findings in the Searle report. One that people have tended to be interested in is how the cases come out. What we found is that consumers win some relief in roughly 53 percent of the cases in which they bring claims, and they are awarded just under $20,000 on average. Businesses win some relief in roughly 83 percent of the cases they bring and are awarded just over $20,000.

The fact that businesses prevail more often does not show that there is any unfairness in the arbitration process. To the contrary, what is likely the case is that businesses bring different claims than consumers bring.

The business claimants were very different parties than the business respondents. Business claimants tend to be people who provided or businesses that have provided services and are now collecting debts. Consumer claimants tend to bring claims against businesses that have allegedly provided a defective product in some way, shape, or form. They are harder to prove, and they are harder to quantify damages.

What that means is you can't just look at outcome numbers to tell whether arbitration is fair or not. So the Public Citizen studies, which are very interesting, you can't evaluate whether a 94 percent win rate shows arbitration is fair or unfair without something to compare it to; i.e., how comparable cases come out in court.

Thank you very much.

Mr. COHEN. Thank you, Professor Drahozal. Appreciate it.

[The prepared statement of Mr. Drahozal follows:]

PREPARED STATEMENT OF CHRISTOPHER R. DRAHOZAL

Statement of Christopher R. Drahozal

John M. Rounds Professor of Law
University of Kansas School of Law

Chair, Consumer Arbitration Task Force
Searle Civil Justice Institute

May 5, 2009

House Judiciary Committee
Subcommittee on Commercial and Administrative Law

Hearing on the "Federal Arbitration Act:
Is the Credit Card Industry Using the Act
to Slam Shut the Courthouse Door?"

Chairman Cohen, Ranking Member Franks, and Members of the Subcommittee:
I appreciate the opportunity to testify about the arbitration of disputes arising out of agreements between credit card issuers and cardholders. I am the John M. Rounds Professor of Law at the University of Kansas School of Law, and the Chair of the Consumer Arbitration Task Force of the Searle Civil Justice Institute. I also am an Associate Reporter for the Restatement, Third, of the U.S. Law of International Commercial Arbitration, and have written extensively on the law and economics of arbitration.

Overview

The use of arbitration clauses in credit cardholder agreements is widespread,[1] and the practice of resolving credit card disputes through arbitration has been controversial.[2] Increasingly, both critics and supporters of the practice have come to recognize the importance of empirical evidence in making sound public policy decisions in the area.[3] Indeed, Professor Peter B. Rutledge has recently written that "there now appears to be a consensus that the future of arbitration should be decided by data, not anecdote."[4]

My testimony today addresses the empirical evidence on five key issues dealing with the use of arbitration to resolve credit card disputes: (1) the upfront costs to consumers of resolving disputes through arbitration; (2) the fairness of procedures in arbitration; (3) how consumers fare in arbitration; (4) whether arbitrators are biased in favor of repeat players (in this case, credit card issuers); and (5) the relationship between arbitration and class actions. Some of these concerns arise only when consumers are claimants, in particular the upfront costs of arbitration and the relationship between arbitrations and class actions. The other issues arise both in cases with consumer claimants and in cases with business claimants.

An important source for my testimony is a new empirical study entitled "Consumer Arbitration Before the American Arbitration Association," recently issued by the Consumer

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[1] Theodore Eisenberg, Geoffrey P. Miller, & Emily Sherwin, *Arbitration's Summer Soldiers: An Empirical Study of Arbitration Clauses in Consumer and Nonconsumer Contracts*, 41 U. MICH. J.L. REF. 871, 882-83 (2008) (reporting that 76.9 percent of a sample of consumer financial and cell phone contracts included arbitration clauses); Linda J. Demaine & Deborah R. Hensler, *"Volunteering" to Arbitrate Through Predispute Arbitration Clauses: The Average Consumer's Experience*, 67 LAW & CONTEMP. PROBS. 55, 62 (2004) (finding that "[t]he prevalence of arbitration clauses is highest (69.2%) in the financial category (credit cards, banking, investment, and accounting/tax consulting)").

[2] E.g., Public Citizen, The Arbitration Trap: How Credit Card Companies Ensnare Consumers (Sept. 2007), *available at* http://www.citizen.org/documents/ArbitrationTrap.pdf.

[3] Peter B. Rutledge, *Whither Arbitration?*, 6 GEO. J.L. PUB. POL'Y 549, 589 (2008) (concluding that "[i]ncreased congressional attention" to consumer and employment arbitration "can be valuable, for it promotes discussion and study about this valuable dispute resolution tool" but also "can be dangerous if the terms of the debate focus too much on anecdote and too little on systematic study"); Public Citizen, The Arbitration Debate Trap: How Opponents of Corporate Accountability Distort the Debate on Arbitration 2 (2008), *available* at http://www.citizen.org/documents/ArbitrationDebateTrap(Final).pdf ("Rutledge concludes *Whither* with the warning that congressional scrutiny of arbitration 'can be dangerous if the terms of the debate focus too much on anecdote and too little on systematic study.' We agree.").

[4] Peter B. Rutledge, *Common Ground in the Arbitration Debate*, Y.B. ARB. & MED. ___, ___ (forthcoming 2009).

Arbitration Task Force of the Searle Civil Justice Institute ("SCJI"). The study is the most comprehensive empirical research to date on consumer arbitration procedures and outcomes. A copy of the Executive Summary is appended at the end of this statement, and a full copy of the study is available at www.searlearbitration.org.

Searle Civil Justice Institute Task Force on Consumer Arbitration

Founded in early 2008 as a division of the Searle Center on Law, Regulation, and Economic Growth, the SCJI aims to become the preeminent national source of large-scale, empirical studies on public policy issues related to our nation's civil justice system. An operating premise of the SCJI is that hard data is a powerful and necessary tool in public policy debates.

The American Arbitration Association ("AAA") is a leading provider of arbitration services, including arbitrations between consumers and businesses. SCJI commissioned a Task Force to advise and lead this study of AAA consumer arbitrations. Funding for the study came exclusively from the initial grant establishing the Searle Center from the late Daniel C. Searle, longtime philanthropist and Northwestern University trustee.

Data and Methodology

The Task Force reviewed a sample of AAA case files involving consumer arbitrations. The primary dataset consists of 301 AAA consumer arbitrations that were closed by an award between April and December of 2007. (The focus on cases closed by an award during this particular timeframe is based on the availability of the original case files.) Slightly under ten percent of the cases in the sample, both cases brought by consumers and cases brought by businesses, involved credit card disputes. Most of the cases in the sample brought by businesses, including the cases brought by credit card issuers, were debt collection cases.

The sample of cases was then coded for approximately 200 variables describing various aspects of the arbitration process. In addition, when possible a broader AAA dataset comprising all consumer cases closed between 2005 and 2007 was utilized. The data were analyzed using standard statistical methods in order to describe and evaluate consumer arbitrations as administered by the AAA. Prior to release, the report was reviewed by independent academic experts on arbitration and empirical studies, including both critics and supporters of consumer arbitration. It also was subject to review by the SCJI Board of Overseers, which consists of general counsels, plaintiffs' lawyers, defense lawyers, academics, and state and federal judges.

Issues

Although the Searle study is ongoing and will ultimately examine many aspects of AAA consumer arbitrations, the initial research inquiries were directed at two general topics: (1) the costs, speed, and outcomes of AAA consumer arbitrations; and (2) AAA enforcement of the

Consumer Due Process Protocol. Each of the issue regarding credit card arbitrations fall within these two general topics.

1. Costs

Arbitration differs from litigation in that it is a private dispute resolution process. Unlike litigation, in which taxpayers pay the salaries of judges and the costs of court administration, in arbitration the parties themselves must pay those costs. Critics of consumer arbitration have contended that these upfront costs deter consumers from asserting claims in arbitration.[5] The Searle study examines the steps the AAA has taken to mitigate such risks.

Like other leading arbitration providers, the AAA has adopted consumer arbitration rules that provide for low-cost arbitration of small consumer claims.[6] Under those rules, the total fee to be paid by a consumer asserting a claim for $10,000 or less is $125, which the AAA applies solely to the arbitrator's fee.[7] The total fee to be paid by a consumer asserting a claim of between $10,000 and $75,000 is $375, again applied solely to the arbitrator's fee.[8] All administrative fees and the remaining arbitrator's fees are to be paid by the business.[9] In cases of financial hardship, the consumer can seek deferral or waiver of administrative fees, as well as the appointment of an arbitrator serving on a pro bono basis.[10] Moreover, the arbitrator is authorized to reallocate administrative and arbitrator's fees between consumers and businesses in the award.[11] Finally, if the arbitration agreement provides for the business to pay a greater share (and the consumer a lesser share) of the arbitration fees, which a number of clauses do, then the clause controls.

The Searle study found that the fees assessed to consumer claimants bringing small claims are on average below the levels specified in the AAA fee schedule, as a result of businesses agreeing in the arbitration agreement to pay a greater share of the costs and arbitrators reallocating consumer fees to businesses in the award. In cases with claims of less than $10,000, consumer claimants were assessed an average of $96 ($1 administrative fees plus $95 arbitrator fees). In cases with claims of between $10,000 and $75,000, consumer claimants were assessed an average of $219 ($15 administrative fees plus $204 arbitrator fees). Thus, the effective fees

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5 *E.g.*, Public Citizen, The Costs of Arbitration 1 (2002) (stating that the upfront costs of arbitration "have a deterrent effect, often preventing a claimant from even filing a case."). For a detailed analysis of this issue, see Christopher R. Drahozal, *Arbitration Costs and Contingent Fee Contracts*, 59 VAND. L. REV. 729 (2006).

6 *See* American Arbitration Association, Supplementary Procedures for the Resolution of Consumer-Related Disputes (effective Sept. 15, 2005).

7 *Id.* Rule C-8 ("Fees and Deposits to be Paid by the Consumer").

8 *Id.* For cases seeking more than $75,000, the fee schedule in the AAA Commercial Arbitration Rules applies..

9 *Id.* Rule C-8 ("Fees and Deposits to be Paid by the Business: *Arbitrator Fees*"); *id.* Rule C-8 ("Fees and Deposits to be Paid by the Business: *Administrative Fees*").

10 American Arbitration Association, Administrative Fee Waivers and Pro Bono Arbitrators ("Pro Bono Service by Arbitrators"), *available at* www.adr.org/si.asp?id=22040 ("A number of arbitrators on the AAA panel have volunteered to serve pro bono for one hearing day on cases where an individual might otherwise be financially unable to pursue his or her rights in the arbitral forum.").

11 American Arbitration Association, Commercial Arbitration Rules, Rule R-43(c) (amended and effective Sept. 1, 2007).

for consumer arbitration in these cases were less than indicated in the applicable arbitration rules, and may have been less than court filing fees.

Any full comparison of the costs of arbitration and litigation needs to take into account all the costs of the dispute resolution process, especially attorneys' fees. Of course, consumers who proceed pro se do not pay any attorneys' fees. For consumers who are represented by an attorney, however, we have no data on what those attorneys' fees were in the cases in our sample or how they compared to the attorneys' fees the consumer would have incurred in litigation. A number of commentators have suggested that attorneys' fees likely are lower in arbitration than in litigation.[12] Without solid empirical data, however, any comparison of arbitration costs to litigation costs necessarily is incomplete.

The study did find, however, that arbitrators awarded attorneys' fees to prevailing consumer claimants in a substantial proportion of cases in which the consumer sought such an award. Consumer claimants sought to recover attorneys' fees in over 50% of the cases in which they were awarded damages, and were awarded attorneys' fees in 63.1% of those cases. In those cases in which the award of attorneys' fees specified a dollar amount, the average attorneys' fee award was $14,574. Although the awards generally did not indicate the basis for the award of attorneys' fees, the substantial majority of the cases were not of the sort in which a fee-shifting statute would be applicable.

2. Procedural Fairness

In response to concerns about unfair procedures in arbitration, leading arbitrator providers have adopted "due process protocols" – privately developed standards of fair procedure in consumer (and employment) arbitration.[13] Due process protocols commonly require independent and impartial arbitrators, reasonable costs, convenient hearing locations, and remedies comparable to those available in court. The AAA has pledged not to administer arbitrations arising out of arbitration clauses that violate the Consumer Due Process Protocol, which applies to credit card arbitrations. Previously, empirical evidence on the effectiveness of such private enforcement efforts had been lacking.[14]

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12 *E.g.*, Samuel Estreicher, *Saturns for Rickshaws: The Stakes in the Debate over Predispute Employment Arbitration Agreements*, 16 OHIO ST. J. ON DISP. RESOL. 559, 564 (2001); Rutledge, *supra* note 3, at 576-79.

13 National Consumer Disputes Advisory Committee, Consumer Due Process Protocol (April 17, 1998), *available at* www.adr.org/sp.asp?id=22019; *see also* Task Force on Alternative Dispute Resolution in Employment, Due Process Protocol for Mediation and Arbitration of Statutory Disputes Arising Out of the Employment Relationship (May 9, 1995), *available at* www.adr.org/sp.asp?id=28535; Commission on Health Care Dispute Resolution, Health Care Due Process Protocol (July 27, 1998), *available at* www.adr.org/sp.asp?id=28633; JAMS, JAMS Policy on Consumer Arbitrations Pursuant to Pre-Dispute Clauses: Minimum Standards of Procedural Fairness (revised Jan. 1, 2007), *available at* www.jamsadr.com/rules/consumer_min_std.asp; JAMS, JAMS Policy on Employment Arbitration, Minimum Standards of Procedural Fairness (revised Feb. 19, 2005), *available at* www.jamsadr.com/rules/employment_Arbitration_min_stds.asp; National Arbitration Forum, Arbitration Bill of Rights (2007), *available at* www.adrforum.com/users/naf/resources/ArbitrationBillOfRights3.pdf.

14 W. Mark C. Weidemaier, *Arbitration and the Individuation Critique*, 49 ARIZ. L. REV. 69, 107 (2007); *see also id.* at 93 n.138.

The Searle study provided the first empirical evidence on the enforcement of due process protocols. It found that a substantial majority of consumer arbitration clauses in the sample (76.6%) fully complied with the Consumer Due Process Protocol when the case was filed. Moreover, the AAA's review of arbitration clauses for protocol compliance was effective at identifying and responding to clauses with protocol violations. In 98.2% of cases in the sample subject to AAA protocol compliance review, the arbitration clause either complied with the Due Process Protocol or the non-compliance was properly identified and addressed by the AAA.

Moreover, the Searle study found evidence that businesses modify their arbitration clauses as a result of the AAA's protocol compliance review to make them consistent with the Consumer Due Process Protocol. In response to AAA review, more than 150 businesses either waived problematic provisions on an ongoing basis or revised arbitration clauses to remove provisions that violated the Consumer Due Process Protocol. This is in addition to the more than 1550 businesses identified by the AAA as having arbitration clauses that comply with the Protocol. By comparison, AAA has identified 647 businesses for which it will not administer arbitrations because of Protocol violations, most commonly the business's failure to pay its share of the arbitration fees.

3. Outcomes

A central controversy in discussions of credit card arbitration is how consumers fare. A number of empirical studies have examined the success rate of credit cardholders in arbitration. Most of those studies have focused on cardholders as respondents in arbitration, and have used data on arbitrations administered by the National Arbitration Forum. The studies find a win-rate for business claimants (almost exclusively credit card issuers or their assigns) ranging from 67.9% to over 99%.[15] Much of the variation in these results is due to differences in how the studies treat cases that are dismissed before an award. The win-rate for consumer claimants (who are rare in NAF arbitrations) ranges from 37.2% to 65.5%.[16]

By comparison, the Searle study found that consumers won some relief in 53.3% of the cases they filed and recovered an average of $19,255, while business claimants won some relief in 83.6% of their cases and recovered an average of $20,648. The average award to a successful

[15] Mark Fellows, *The Same Result as in Court, More Efficiently: Comparing Arbitration and Court Litigation Outcomes*, METRO. CORP. COUNSEL, July 2006, at 32 (business claimants "prevail in 77.7% of the cases that reach a decision"); Jeff Nielsen et al., Navigant Consulting, National Arbitration Forum: California Consumer Arbitration Data 1 (July 11, 2008), *available at* http://www.instituteforlegalreform.com/index.php?option=com_ilr_docs&issue_code=ADR&doc_type=STU (businesses prevailed in 67.9% of NAF arbitrations either heard by an arbitrator or dismissed); Public Citizen, Arbitration Trap, *supra* note 2, at 15 ("In 19,294 cases in which an arbitrator was appointed, the business won in 18,091 (or 93.8%)"); Answers and Objections of First USA Bank, N.A. to Plaintiff's Second Set of Interrogatories, Ex. 1, Bownes v. First U.S.A. Bank, N.A. et al., Civ. Action No. 99-2479-PR (Ala. Circuit Ct. 2000), *available* at http://www.tlpj.org/briefs/McQuillan%20exhibits%2016-19%20(300dpi).pdf (last visited Dec. 10, 2008) (bank prevailed in 19,618 NAF arbitrations, while credit cardholder prevailed in 87).

[16] Ernst & Young, Outcomes of Arbitration: An Empirical Study of Consumer Lending Cases 8 (2004), *available at* http://www.adrforum.com/rcontrol/documents/ResearchStudiesAndStatistics/2005ErnstAndYoung.pdf (win-rate for consumer claimants of 54.6%); Fellows, *supra* note 16, at 32 (win-rate for consumer claimants of 65.5%); Public Citizen, Arbitration Debate Trap, *supra* note 3, at 10 (win-rate for consumer claimants of 37.2%).

consumer claimant in the sample was 52.1% of the amount claimed and to a successful business claimant was 93.0% of the amount claimed. This difference in win-rate and percent recovery between business claimants and consumer claimants appears to be driven in important part by differences in the types of claims brought by consumers and business. Business claims are almost exclusively for payment of goods and services while consumer claims are seeking recovery for non-delivery, breach of warranty, and consumer protection violations.[17]

These data face an important limitation, however, one to which studies of outcomes in credit card arbitration are likewise subject: the absence of a baseline for comparison. A fifty percent win-rate for claimants may be extremely high if claimants bringing similar claims tend to win at a lower rate in court, or extremely low if claimants bringing similar claims tend to win at a higher rate in court. For example, the available evidence suggests that business claimants tend to prevail at a very high rate in debt collection actions in court.[18] If so, then the high win-rate of businesses in credit card arbitrations is not particularly problematic.

4. Repeat-Arbitrator Bias

A related concern is so-called "repeat-arbitrator bias." Unlike judges, who get paid regardless of how many cases they decide, arbitrators get paid only when they are selected to decide a case. These differing compensation structures have given rise to fears that arbitrators will be biased in favor of "repeat players," parties that are more likely to be in a position to appoint the arbitrator in a future case.[19] In credit card arbitrations, the credit card issuer is a repeat player; cardholders are unlikely to be repeat players, although their attorneys may be.

Prior academic studies have some found evidence of a "repeat-player effect" – that repeat players have higher win-rates in arbitration than non-repeat players. But the studies have generally attributed the repeat-player effect to better screening of cases by repeat players rather than bias by arbitrators.[20] The findings of the Searle study are similar.

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[17] Again, as noted above, the Searle study does not break out its results by type of business, so we do not have results on arbitration outcomes specific to credit card arbitrations.

[18] *E.g.*, Urban Justice Center, Debt Weight: The Consumer Credit Crisis in New York City and Its Impact on the Working Poor 17 (Oct. 2007) (in New York City Civil Court cases studied, 81.8 percent of consumer credit lawsuits filed were resolved by default judgment in favor of creditor); John A. Goerdt, Small Claims and Traffic Courts: Case Management Procedures, Case Characteristics and Outcomes in 12 Urban Jurisdictions 53 (1992) (National Center for State Courts) (finding business win-rate against individual claimants of 87 percent in small claims court).

[19] *E.g.*, Richard M. Alderman, *Pre-Dispute Mandatory Arbitration in Consumer Contracts: A Call for Reform*, 38 HOUS. L. REV. 1237, 1256 (2001); David S. Schwartz, *Enforcing Small Print to Protect Big Business: Employee and Consumer Rights Claims in an Age of Compelled Arbitration*, 1997 WIS. L. REV. 33, 60-61; *see also* Public Citizen, Arbitration Debate Trap, *supra* note 3, at 24-26.

[20] *E.g.*, Lisa B. Bingham, *Unequal Bargaining Power: An Alternative Account for the Repeat Player Effect in Employment Arbitration*, IRRA 50TH ANN. PROC. 33, 39-40 (1998); Lisa B. Bingham & Shimon Sarraf, *Employment Arbitration Before and After the Due Process Protocol for Mediation and Arbitration of Statutory Disputes Arising Out of Employment: Preliminary Evidence that Self-Regulation Makes a Difference*, *in* ALTERNATE DISPUTE RESOLUTION IN THE EMPLOYMENT ARENA: PROCEEDINGS OF THE NEW YORK UNIVERSITY 53RD ANNUAL CONFERENCE ON LABOR 303, 323 tbl. 2 (Samuel Estreicher & David Sherwyn eds. 2004); Elizabeth Hill, *AAA Employment Arbitration: A Fair Forum at Low Cost*, DISP. RESOL. J., May/July 2003, at 15.

First, the study found no statistically significant repeat-player effect using a traditional definition of repeat-player business. Consumer claimants won some relief in 51.8% of cases against businesses that appear more than once in the AAA dataset (repeat businesses) and 55.3% of cases against businesses that appear only once (non-repeat businesses) – a difference that is not statistically significant.

Second, using an alternative definition of repeat player, some evidence of a repeat-player effect was identified. Consumer claimants won some relief in 43.4% of cases against repeat businesses and 56.1% against non-repeat businesses (as defined based on the AAA's categorization of businesses in enforcing the Consumer Due Process Protocol) – a difference that is statistically significant at the 10% level. However, 71.1% of consumer claims against repeat businesses so defined were resolved prior to an award, while only 54.6% of claims against non-repeat businesses were resolved prior to an award. This suggests that the repeat-player effect is attributable to better case screening by repeat players (i.e., settling stronger consumer claims and arbitrating weaker claims), rather than arbitrator bias.

5. Class Relief

Another criticism of arbitration clauses in consumer contracts, including but not limited to credit card contracts, is that they prevent consumer claims from being resolved in class actions.[21] When parties agree to arbitration, they contract out of court proceedings, including class action proceedings. While class actions in arbitration ("class arbitrations") have become more common in recent years,[22] at least some businesses have responded by including class arbitration waivers – provisions that waive the availability of class proceedings in arbitration – in their standard form contracts. These developments have led to fears that consumers are being denied remedies, and even that class actions will soon become extinct.[23] The available empirical evidence suggests that such fears are overblown.

Overall, most of the arbitration clauses in the sample of AAA consumer arbitrations did *not* include class arbitration waivers. Only 36.5% of the cases arose out of arbitration clauses with a class arbitration waiver; 63.5% arose out of arbitration clauses without a class arbitration waiver. Moreover, the use of class arbitration waivers varied widely by industry. It plainly is not the case that all arbitration clauses preclude recovery on a class basis.

By comparison, and consistent with prior studies,[24] the Searle study found that all credit card arbitration agreements in the sample did include class arbitration waivers. That fact, however, does not necessarily mean that cardholders will be unable to proceed on a class basis. Rather, current law allows the courts to examine the enforceability of class arbitration waivers on a case-by-case basis. According to Alan Kaplinsky et al., an "increasing number of state courts

21 *E.g.*, Public Citizen, Arbitration Trap, *supra* note 2, at 43.

22 The growth of class arbitration proceedings has occurred as a result of the Supreme Court's decision in *Green Tree Financial Corp. v. Bazzle*, 539 U.S. 444 (2003).

23 *E.g.*, Myriam Gilles, *Opting Out of Liability: The Forthcoming, Near-Total Demise of the Modern Class Action*, 104 MICH. L. REV. 373, 375 (2005).

24 *See* Eisenberg, Miller, & Sherwin, *supra* note 1, at 884.

have shown hostility" toward consumer arbitration agreements with class arbitration waivers, and "[a] number of state appellate courts have invalidated class action waivers within the past couple of years."[25] Some federal courts have done so as well.[26] Because many credit card contracts provide that if a court holds the class arbitration waiver invalid the entire arbitration clause is invalid,[27] class claims filed in such jurisdictions may well end up in court, or at the very least in a class arbitration proceeding.[28] In short, class proceedings may continue to be available even for consumers who are parties to an arbitration clause with a class arbitration waiver.

Finally, assuming that credit card issuers view class arbitration waivers as critical components of their arbitration agreements, important empirical questions remain unanswered, such as:

- How frequent are class actions against credit card companies? What kinds of class actions have been brought (i.e., what is the nature of the alleged violations and the requested relief)? How much have cardholders recovered? What costs have credit card issuers incurred?

- How effective are possible alternatives to class actions – including individual arbitrations, class arbitrations, and formal and informal regulatory proceedings? What kinds of claims have been pursued in these proceedings? How much have cardholders recovered? What costs have credit card issuers incurred?

The next phase of the Searle study will consider the extent to which class actions are comparable to the individual arbitrations in the sample, for purposes of developing a baseline for evaluating the costs, speed, and outcomes of AAA consumer arbitrations. But much more research remains to be done in order to evaluate in a meaningful way the relationship between arbitration and class actions.[29]

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[25] Alan S. Kaplinsky, Mark J. Levin, and Martin C. Bryce, Jr., *Consumer Arbitration: The Tug of War Between the Federal and State Courts Intensifies*, 64 BUS. LAW. 627, 627-28 (2009).

[26] *See In re* American Express Merchants' Litigation, 554 F.3d 300, 319-20 (2d Cir. 2009).

[27] *See* Eisenberg, Miller, & Sherwin, *supra* note 1, at 885.

[28] For a more complete discussion, see Christopher R. Drahozal & Quentin R. Wittrock, *Franchising, Arbitration, and the Future of the Class Action*, 3 ENTREPRENEURIAL BUS. L.J. ___ (forthcoming 2008).

[29] Some empirical research has been done on these questions for other types of cases. For example, a recent study of employment class actions found that "potential individual recoveries for many types of employment disputes are valuable enough to place in question the arguments that these are 'negative value' cases that will be brought forward, if at all, only through the class action vehicle." Samuel Estreicher & Kristina Yost, *Measuring the Value of Class and Collective Action Employment Settlements: A Preliminary Assessment*, *in* EMPLOYMENT CLASS AND COLLECTIVE ACTIONS: PROCEEDINGS OF THE N.Y.U. 56TH ANNUAL CONFERENCE ON LABOR 107, 137 (David Sherwyn ed. 2009). That said, the mean and median potential individual recoveries in the class actions studied were consistently less than the mean and median recoveries in individual employment arbitrations reported in other studies. *Id.* at 136.

Limitations and Conclusions

While the empirical results presented in the Searle study are the most comprehensive available and thus may usefully inform the policy debate on consumer arbitration, the study nonetheless has limitations. First, its findings are limited to AAA consumer arbitration. Empirical results from studying AAA consumer arbitration do not necessarily apply to other arbitration providers. That said, in setting national policy concerning arbitration, information on consumer arbitrations administered by the AAA, a leading provider of arbitration services, certainly is necessary for making an informed decision.

Second, as discussed above, the study's findings on the costs and outcomes of AAA consumer arbitrations are difficult to interpret without a baseline for comparison. The next phase of this research project thus will seek to compare the procedures and outcomes in AAA consumer arbitrations with procedures and outcomes in court. Only by undertaking such a comparison is it possible to draw meaningful conclusions about how consumers fare in arbitration.

At bottom, the Searle study reinforces the importance of empirical work in the policy debate over consumer and employment arbitration. Sound policymaking – whether dealing with credit card arbitration in particular or consumer and employment arbitration in general – should consider statistically valid empirical studies, not just anecdotal reports.

Searle Center on Law, Regulation, and Economic Growth

Searle Civil Justice Institute

CONSUMER ARBITRATION BEFORE THE AMERICAN ARBITRATION ASSOCIATION

Executive Summary
March 2009

Issues and Background

Empirical evidence has become a central focus of the policy debate over consumer and employment arbitration. Both supporters and opponents of the proposed Arbitration Fairness Act, which would make pre-dispute arbitration clauses unenforceable in consumer and employment (and franchise) agreements, have recognized that empirical evidence on the fairness and integrity of consumer and employment arbitration proceedings is essential to making an informed decision on the bill. Yet the empirical record, particularly on consumer arbitration, has critical gaps.

One set of issues on which further empirical research would be helpful is the costs, speed, and outcomes of consumer arbitrations. How much do consumers pay to bring claims in arbitration? How long do consumer arbitrations take to resolve? How do consumers fare in arbitration, particularly against businesses that are repeat users of arbitrators and arbitration providers? While a number of important studies on employment arbitration have been provided, the empirical record on these issues in consumer arbitrations is sparse.

A second set of issues of interest involves the enforcement of arbitration due process protocols -- privately created standards setting out minimum requirements of procedural fairness for consumer and employment arbitrations. Due process protocols commonly require independent and impartial arbitrators, reasonable costs, convenient hearing locations, and remedies comparable to those available in court. Leading arbitration providers have pledged not to administer arbitrations arising out of arbitration clauses that violate the protocols. But empirical evidence on the effectiveness of these private enforcement efforts is lacking.

Searle Civil Justice Institute Task Force on Consumer Arbitration

To shed light on these issues, the Searle Civil Justice Institute (SCJI) undertook a large-scale study of consumer arbitrations administered by the American Arbitration Association (AAA). The AAA is a leading provider of arbitration services, including arbitrations between consumers and businesses. SCJI commissioned a Task Force to advise and lead this study of consumer arbitrations. Although the study will ultimately examine many aspects of AAA consumer arbitrations, the initial research inquiries were directed at two topics:

1. *Costs, Speed, and Outcomes of AAA Consumer Arbitrations.* This aspect of the Preliminary Report assesses key characteristics of the AAA consumer arbitration process. In particular, it examines the following research questions:

   - General characteristics of AAA consumer arbitration cases including claimant type (i.e., consumer or business), types of businesses involved, and amounts claimed.
   - Costs of consumer arbitration (arbitrator fees plus AAA administrative fees), including the impact of the arbitrator's power to reallocate such fees in the award.
   - Speed of the arbitration process from filing to award, in the aggregate and by claimant type (i.e., consumer or business).
   - Various measures of outcomes such as win-rates, damages awarded, and evidence of as well as possible explanations for any repeat-player effects.

In addition to these broad research questions, SCJI also examined the extent to which consumer arbitrations are resolved ex parte; the frequency with which arbitrators award attorneys' fees, punitive damages, and interest; and results for consumers proceeding pro se.

2. *AAA Enforcement of the Consumer Due Process Protocol.* This aspect of the Preliminary Report provides an empirical analysis of how effectively the AAA enforces compliance with the Consumer Due Process Protocol. It considers a number of key research questions including:

   - To what extent do the consumer arbitration clauses comply, in their own right, with the Due Process Protocol?
   - How effective is AAA review of arbitration clauses for compliance with the Due Process Protocol?
   - To what extent does the AAA refuse to administer consumer cases because of the failure of businesses to comply with the Due Process Protocol?
   - How do businesses respond to AAA enforcement of the Protocol?

In addition to these research questions, SCJI examined several other issues that arise in connection with the Due Process Protocols.

Data and Methodology

SCJI reviewed a sample of AAA case files involving consumer arbitrations. The primary dataset consists of 301 AAA consumer arbitrations that were closed by an award between April and December of 2007. (The focus on cases closed by an award during this particular timeframe is based on the availability of the original case files.) This sample of cases was then coded for approximately 200 variables describing various aspects of the arbitration process, including a review of the arbitration clause in the file. In addition, when possible a broader AAA dataset comprising all consumer cases closed between 2005 and 2007 was utilized. The AAA maintains this dataset in the ordinary course of its business, collecting data for internal purposes but not recording all variables of interest to SCJI. The data were analyzed using standard statistical methods in order to describe and evaluate consumer arbitrations as administered by the AAA.

Key Findings – Costs, Speed, and Outcomes of AAA Consumer Arbitrations

The upfront cost of arbitration for consumer claimants in cases administered by the AAA appears to be quite low.

In cases with claims seeking less than $10,000, consumer claimants paid an average of $96 ($1 administrative fees + $95 arbitrator fees). This amount increases to $219 ($15 administrative fees + $204 arbitrator fees) for claims between $10,000 and $75,000. These amounts fall below levels specified in the AAA fee schedule for low-cost arbitrations, and are a result of arbitrators reallocating consumer costs to businesses.

AAA consumer arbitration seems to be an expeditious way to resolve disputes.

The average time from filing to final award for the consumer arbitrations studied was 6.9 months. Cases with business claimants were resolved on average in 6.6 months and cases with consumer claimants were resolved on average in 7.0 months.

Consumers won some relief in 53.3% of the cases they filed and recovered an average of $19,255; business claimants won some relief in 83.6% of their cases and recovered an average of $20,648.

The average award to a successful consumer claimant in the sample was 52.1% of the amount claimed and to a successful business claimant was 93.0% of the amount claimed. This result appears to be driven by differences in types of claims initiated by consumers and business. Business claims are almost exclusively for payment of goods and services while consumer claims are seeking recovery for non-delivery, breach of warranty, and consumer protection violations.

No statistically significant repeat-player effect was identified using a traditional definition of repeat-player business.

Consumer claimants won some relief in 51.8% of cases against repeat businesses under a traditional definition (i.e., businesses who appear more than once in the AAA dataset) and 55.3% against non-repeat businesses – a difference that is not statistically significant.

Utilizing an alternative definition of repeat player, some evidence of a repeat-player effect was identified; the data suggests this result may be due to better case screening by repeat players.

Consumer claimants won some relief in 43.4% of cases against repeat businesses and 56.1% against non-repeat businesses under an alternative definition (based on the AAA's categorization of businesses in enforcing the Consumer Due Process Protocol) – a difference that is statistically significant at the 10% level. However, 71.1% of consumer claims against repeat businesses so defined were resolved prior to an award, while only 54.6% of claims against non-repeat businesses were resolved prior to an award. This suggests that such effect is attributable to better case screening by repeat players (i.e., settling stronger consumer claims and arbitrating weaker claims).

Arbitrators awarded attorneys' fees to prevailing consumer claimants in 63.1% of cases in which the consumer sought such an award.

Consumer claimants sought to recover attorneys' fees in over 50% of the cases in which they were awarded damages and were awarded attorneys' fees in 63.1% of those cases. In those cases in which the award of attorneys' fees specified a dollar amount, the average attorneys' fee award was $14,574.

Key Findings – AAA Enforcement of the Due Process Protocol

A substantial majority of consumer arbitration clauses in the sample (76.6%) fully complied with the Due Process Protocol when the case was filed.

Most arbitration clauses in consumer contracts that come before the AAA are consistent with the Consumer Due Process Protocol as applied by the AAA. The same is true for cases in which protocol compliance was a matter for the arbitrator to enforce.

AAA's review of arbitration clauses for protocol compliance was effective at identifying and responding to clauses with protocol violations.

In 98.2% of cases in the sample subject to AAA protocol compliance review, the arbitration clause either complied with the Due Process Protocol or the non-compliance was properly identified and responded to by the AAA.

The AAA refused to administer a significant number of consumer cases because of Protocol violations by businesses.

In 2007, the AAA refused to administer at least 85 consumer cases, and likely at least 129 consumer cases (9.4% of its consumer case load), because the business failed to comply with the Consumer Due Process Protocol. The most common reason for refusing to administer a case (55 of 129 cases, or 42.6%) was the business's failure to pay its share of the costs of arbitration rather than any problematic provision in the arbitration clause.

As a result of AAA's protocol compliance review, some businesses modify their arbitration clauses to make them consistent with the Consumer Due Process Protocol.

In response to AAA review, more than 150 businesses have either waived problematic provisions on an ongoing basis or revised arbitration clauses to remove provisions that violated the Consumer Due Process Protocol. This is in addition to the more than 1550 businesses identified by the AAA as having arbitration clauses that comply with the Protocol. By comparison, AAA has identified 647 businesses for which it will not administer arbitrations because of Protocol violations.

Policy Implications and Next Steps

The empirical findings in the SCJI Preliminary Report on AAA consumer arbitrations have important implications for those interested in discussing and formulating public policy regarding arbitration.

1. Not all consumer arbitrations, arbitration providers, or arbitration clauses are alike. Differing results from empirical studies of arbitration may reflect variations associated with case mix, type of claimant, or provider review processes. This suggests the need for a nuanced approach to public policy concerning arbitration.

2. Private regulation complements existing public regulation of the fairness of consumer arbitration clauses. Policy makers should not ignore the role that arbitration providers can play in promoting fairness on behalf of consumers.

3. Courts could usefully reinforce the AAA's enforcement of the Consumer Due Process Protocol by declining to enforce an arbitration clause when the AAA has refused to administer an arbitration arising out of the clause or by otherwise reinforcing the role of the Due Process Protocol.

4. Arbitration may be less expensive for consumers than sometimes believed. For many consumers, the AAA arbitration process costs less than the amount specified in the AAA rules because arbitrators often shift some portion of the costs to businesses. Moreover, arbitrators award attorneys' fees to a substantial proportion of prevailing consumers in AAA consumer arbitrations.

5. Empirical studies have tended to find that repeat players fare better in arbitration than non-repeat players. To the extent such a repeat-player effect exists in arbitration, the critical policy question is what causes it. Our findings are consistent with prior studies in suggesting that any repeat-player effect is likely caused by better case screening by repeat players rather than arbitrator (or other) bias in favor of repeat players. A further as yet unresolved question is whether a repeat-player effect exists in litigation, and, if so, how litigation compares to arbitration in this regard.

While the empirical results presented in the SCJI Preliminary Report on Consumer Arbitration may usefully inform the policy debate on consumer arbitration, the Report nonetheless has limitations. First, its findings are limited to AAA consumer arbitrations. Empirical results from studying AAA consumer arbitration do not necessarily apply to other arbitration providers. Second, its findings on the costs, speed, and outcomes of AAA consumer arbitrations are difficult to interpret without a baseline for comparison, such as the procedures and practices in traditional court proceedings. A future phase of this research project by the Searle Civil Justice

Institute's Task Force on Consumer Arbitration will undertake that comparison. It will seek to compare the procedures in AAA consumer arbitration with procedures available for consumers in court as well as comparing empirically key process characteristics of courts and arbitration.

Mr. COHEN. Our final witness is David Arkush. Mr. Arkush is the Director of Congress Watch. He joined Public Citizen in January, 2008, after working as a staff attorney for Public Justice, where he litigated civil rights, environmental, and consumer cases primarily in the area of Federal preemption of State law, private standing under consumer protection statutes, and binding mandatory arbitration in consumer contracts.

Prior to working at Public Justice, Mr. Arkush taught at the Appellate Litigation Program at Georgetown University Law, served as the Fuchsberg Fellow at Public Citizen Litigation Group, and clerked for the Honorable R. Lanier Anderson, III of the U.S. Court of Appeals Eighth Circuit.

Before clerking, Mr. Arkush worked for the private public interest firm Adkins, Kelston and Chavez; and before law school he served as Statewide coordinator of Missouri Voters for Fair Elections.

Thank you, Mr. Arkush. Will you proceed with your testimony.

TESTIMONY OF DAVID ARKUSH, ESQ., PUBLIC CITIZEN

Mr. ARKUSH. Thank you, Mr. Chairman, Members of the Subcommittee.

Forced arbitration in the credit card industry serves three primary functions. First, it allows credit card companies and debt collectors to wring more unfair fees out consumers, sometimes the consumers who are least able to pay them. Second, it makes it easier for debt collectors to collect on debts when they lack sufficient——

Mr. COHEN. You might want to pull your microphone up a little bit. Thank you, sir.

Mr. ARKUSH. Second, it enables debt collectors to collect on debts when they lack sufficient evidence or even when the debts are unlawful. And, third, it provides a shield from accountability for unfair practices.

Arbitration, forced arbitration in the consumer context has nothing to do with providing consumers a faster, cheaper, and fair forum to bring disputes.

On the first two points, unfair fees and collection, I have a story to tell that illustrates those points.

Cheryl Betts of North Carolina missed one payment. She was late for one payment on her Chase credit card. In response, Chase lowered her credit limit from $6,000 to $4,900, charged her extra fees, charged her a penalty interest rate. Those fees and penalty interest soon pushed her over the new credit limit. That spurred a new cycle of fees and penalty interest. She tried to work out a payment plan with Chase but wasn't able to.

Two years later, she received a letter in the mail saying that she was being taken to arbitration. She owed over $6,000; and to her debt had been added $602 in legal fees, over 10 percent of the debt. She wrote an 11-page response, to which the debt collection law firm responded by seeking an adjournment, which indefinitely suspended the arbitration.

Four months later, she wrote another long letter disputing the debt, to which the debt collection firm responded by seeking a 45-day extension. One day after the 45-day extension expired and the debt collection firm still had not responded to Ms. Bett's arguments, the NAF arbitrator ruled in the debt collection firm's favor.

In sum, in an NAF arbitration, Ms. Betts was first charged extra fees; second, the debt collection firm never responded to her arguments; third, the debt collection firm missed its own extended deadline to respond to her arguments; and, fourth, the debt collection firm won. This is not a fair process. This is not a process that has anything to do with providing consumers a benefit.

The third point in terms of what arbitration currently does in the credit card industry is that it is a shield from accountability for unfair practices. Because there are no class actions in credit card arbitrations, that means consumers generally can't bring any claims at all. As Judge Posner famously said, only a lunatic or a fanatic would bring a small claim individually in court. We need class actions if many of these people are to bring cases at all.

The evidence bears out that it is too difficult for consumers to bring cases individually in arbitration because when we at Public Citizen studied 34,000 NAF arbitrations from 2003 to 2007, this is 34,000 arbitrations, only 118 of them were brought by consumers.

Forced arbitration is about denying access to justice for consumers. It is not about providing them a fair, efficient, and inexpensive forum.

Proponents of arbitration try to show benefits. They have failed to meet their burden of showing that arbitration benefits consumers. We debunked the majority of these studies that have been done last summer in a thorough report.

There is new study from my colleague to my right here, Professor Drahozal, again purporting to show that forced arbitration benefits consumers. It suffers from similar flaws to all studies that have preceded it.

First, it is based on Triple A arbitrations. Triple A is not a major provider of consumer arbitration. It is not the right place to look if you want to find answers to these questions.

Second, the study's own data shows that consumers do worse than businesses. Consumers won 53 percent of the time and got 52 percent of what they asked for. Businesses won 83 percent of the time and got 93 percent of what they asked for. That means consumers overall got 28 percent of what they wanted and businesses got 78 percent of what they wanted. That doesn't look fair at a glance.

The study is also missing key data largely because of timing. We have done a preliminary analysis of cases that they missed. Of 61,000 cases since 2004, 45,000 come from a single debt collection firm, Midland Credit Management, that came in after this study's data set concluded. In 87 percent of those cases, Triple A awarded exactly amount that Midland Credit Management sought.

The fourth problem is that there is no independent verification of these kinds of numbers that are in the study. The proponents of arbitration have all of the evidence in their hands, and they are afraid to give it up. Instead, we are forced to fight with table scraps of evidence, and we are still winning the fight on this side.

This empirical debate, with all due respect, is a bit of a distraction. Common sense says that a system where the arbitrators are competing for the business of one side is not fair to the other.

Mr. COHEN. Thank you, Mr. Arkush.

[The prepared statement of Mr. Arkush follows:]

PREPARED STATEMENT OF DAVID ARKUSH

Written Testimony

of

David Arkush,

Director,

Public Citizen's Congress Watch division

before the

HOUSE OF REPRESENTATIVES COMMITTEE ON THE JUDICIARY,

SUBCOMMITTEE ON COMMERCIAL AND ADMINISTRATIVE

LAW

Hearing on the "Federal Arbitration Act": Is the Credit Card Industry Using the Act to Slam Shut the Courthouse Door?"

May 5, 2009

Mr. Chairman and other Members of the Subcommittee, thank you for the opportunity to testify on the critical issue of forced arbitration. My name is David Arkush, and I am the director of Public Citizen's Congress Watch division. Public Citizen is a national nonprofit membership organization that has advanced consumer rights in administrative agencies, the courts, and the Congress, for thirty-eight years.

INTRODUCTION

The Federal Arbitration Act was intended to provide an informal dispute resolution mechanism for businesses to resolve disagreements.[1] At the time, arbitration was voluntary, chosen by sophisticated parties that had bargaining power with respect to each other.[2] In the early 1980s, the United States Supreme Court opened the door for large corporations to force their customers and non-union employees into arbitration,[3] and many have seized the opportunity. Today, a consumer must forego the right to litigate any future disputes in court to obtain a wide range of goods and services, including credit cards.[4] A consumer with a credit-card dispute must bring a claim individually, not as a member of a class, in a private, secretive forum, chosen by the credit card provider. The San Francisco City Attorney has called the leading arbitrator of credit card disputes, the National Arbitration Forum, an "arbitration mill" that "churn[s] out arbitration awards in favor of debt collectors."[5]

Forcing arbitration on credit card customers has nothing to do with providing them a quicker, simpler, less expensive forum in which to pursue disputes, as its proponents claim. Nor is there any evidence that forced arbitration provides consumers with cheaper credit. The real functions of forced arbitration are (1) to deter consumers from bringing claims at all; and (2) to give creditors a fast-track forum for collecting debts, even unlawful debts, in which they can run up additional fees to charge consumers. In short, forced arbitration is another in a long list of predatory credit card practices.

DISCUSSION

I. Forced Arbitration Is One of Many Predatory Credit Card Practices.

American consumers have a strong distaste for credit card providers because of their experiences with abusive practices such as hidden fees and complicated,

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[1] *See* Jean Sternlight, *Creeping Mandatory Arbitration: Is It Just*, 57 STAN. L. REV. 1631, 1636 (2005).
[2] *Id.* at 1635-36.
[3] *See generally* David S. Schwartz, *If You Love Arbitration, Set It Free: How "Mandatory" Undermines "Arbitration"*, 8 NEV. L. J. 400 (2007).
[4] *See* Theodore Eisenberg & Geoffrey Miller, *Arbitration's Summer Soldiers: An Empirical Study of Arbitration Clauses in Consumer and Non-Consumer Contracts*, 41 U. MICH. J.L. REFORM 871, 871 (2008).
[5] Sam Zuckerman, *S.F. Sues Credit Card Service, Alleging Bias*, S.F. CHRONICLE, Apr. 8, 2008 at D-1.

deceptive pricing. In the past decade, credit card providers have increased their fees and penalties dramatically:[6]

- In 2005 credit card penalty fees totaled $17.1 billion, a 10-fold increase from 1995, and penalty interest rates averaged 24.2 percent.[7] Lenders collected $18.1 billion in penalty fees on credit cards in 2007.[8]

- The average late fee over the same ten-year period rose from $12.38 in 1995 to $33.64 in 2005.[9] The average overlimit fee is now $30.18.[10]

- In 2002, credit card lenders introduced tiered fee structures that add an automatic prorated fee based upon the balance that the borrower is carrying.[11]

- Lenders also assess fees for various services and transactions.[12] For example, credit card issuers make an estimated $36 million annually in interchange fees that credit card companies charge vendors to use their cards, which are then added to the price of goods and services.

It is currently estimated that credit card issuers make over a third of their money in fees.[13] This is an industry that makes most of its money from its least satisfied customers.

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[6] *See* PUBLIC CITIZEN, THE ARBITRATION TRAP 51 (2007) *at* http://www.citizen.org/documents/ArbitrationTrap.pdf (citing "Credit Cards: Increased Complexity in Rates and Fees Heightens Need for More Effective Disclosures to Consumers," General Accountability Office, Sept. 2006, GAO-06-929); *see also* Oren Bar-Gill & Elizabeth Warren, *Making Credit Safer*, 157 U. PA. L. REV. 1, 46 (2008) ("More recently, long-term interest rates have become more salient to consumers, perhaps reflecting their growing concern over rising balances on credit cards. The design of the credit card product changed in response. Long-term interest rates were reduced to attract and retain customers, as other charges were increased."); *also* Kathy Chu, "Facing Losses on Bad Loans, Banks Boost Credit Card Rates", USA TODAY, Apr. 27, 2008 at http://www.usatoday.com/money/perfi/basics/2008-02-06-consumer-credit-charges_N.htm ("Bank fees have been rising for years. But as their loan losses have surged, banks have become quicker to raise certain fees and rates, analysts say.").

[7] *See* PUBLIC CITIZEN, THE ARBITRATION TRAP at 51 (citing Professor Arthur E. Wilmarth, Jr., George Washington School of Law, testimony before the Financial Institutions and Consumer Credit Subcommittee of the House Financial Services Committee, Apr. 26, 2007).

[8] Chu, *supra*.

[9] Warren & Bar-Gill, *supra*, at 47.

[10] *Id.*

[11] *See* GOVERNMENT ACCOUNTABILITY OFFICE, CREDIT CARDS: INCREASED COMPLEXITY IN RATES AND FEES HEIGHTENS NEED FOR MORE EFFECTIVE DISCLOSURES TO CONSUMERS 19-20 (Sept. 2006) at http://www.gao.gov/new.items/d06929.pdf.

[12] *See id.* at 23.

[13] Elizabeth Hester & Ari Levy, *Credit-Card Users Feel Pain as U.S. Banks Reap Gain*, BLOOMBERG NEWS (Dec. 18, 2008) at http://www.bloomberg.com/apps/news?pid=20601087&sid=ap_9fTPViwzU&refer=home.

Last week, the United States House of Representatives passed a Credit Card Holders Bill of Rights that will halt many of the worst credit card practices. The Senate is scheduled to take up similar legislation this week. Neither bill would address forced arbitration, the subject of today's hearing.

Forced arbitration is in some ways similar to other abusive credit card practices; it can operate as just another in a sequence of steps geared to squeeze additional fees from struggling consumers. In one case, 55-year-old Cheryl C. Betts of Cary, N.C., was late with one $128 minimum payment in August, 2005.[14] Her lender Chase then lowered her credit limit from $6,000 to $4,900 causing more fees and penalty interest to accumulate, eventually pushing her over her new lower limit.[15] Her minimum-payment requirements then rose to a level that she says she couldn't afford.[16] In May, 2007, she learned that she'd been taken to arbitration when debt collection specialists Mann Bracken sent her a letter about $6,027 she owed on a Chase credit card, and requesting an additional $602 in legal fees related to arbitration.[17]

But forced arbitration is different in one key respect: it permits credit card issuers to shield themselves from accountability, thereby enabling and creating incentives to engage in other abusive practices.

II. Forced Arbitration Is Biased Against Consumers, and It Harms Consumers.

A. In Forced Arbitration, the Arbitration Providers Have Strong Incentives to Favor the Business Parties That Choose Them.

Credit card arbitration is required in millions of "take-it-or-leave it" credit card form contracts.[18] These contracts are non-negotiable, and the credit card companies draft all of the terms, so they determine what arbitration provider will be named in the contract. As a result, arbitration companies like the American Arbitration Association (AAA) and the National Arbitration Forum (NAF) compete to be written into these form contracts.[19] An arbitrator's repeat business and the resulting income are determined by his or her reputation ruling in past cases.[20] Arbitration firms market themselves as the business-friendly alternative to court, and they collaborate with law firms that specialize in debt collection to work with

[14] Robert Berner & Brian Grow, *Banks vs. Consumers (Guess Who Wins)*, BUS. WK., June 5, 2008.
[15] *Id.*
[16] *Id.*
[17] *Id.*
[18] *Id.*
[19] *See* Jean Sternlight, *Creeping Mandatory Arbitration: Is It Just*, 57 STAN. L. REV. 1631, 1650 (2005).
[20] *See* Peter B. Rutledge, *Toward A Contractual Approach For Arbitral Immunity*, 39 GA. L. REV. 151, 165 (2004) (Arbitrators "may also develop reputations with particular types of parties. For example, an arbitrator may be perceived as 'industry friendly' in securities law disputes or being 'contractor friendly' in construction disputes. Through these activities designed to enhance their reputations, arbitrators generate business in the form of fees and, hopefully, future appointments.").

the law firms' client base.[21] NAF, the preferred arbitration provider for JPMorgan Chase and Bank of America, promises creditors a "marked increase in recovery rates over existing collection methods."[22] Recently, arbitration provider Judicial Arbitration and Mediation Services (JAMS) revoked its policy against enforcing class action bans in an effort to attract more business from creditors who would be subject to class-based claims.[23] Conversely, arbitration providers have no incentive to please consumers. Most consumers are not even aware that their credit card contracts require arbitration.[24]

Once the arbitration providers are written into credit card contracts, they must ensure that their client companies are pleased with the results of their arbitrations, lest they lose business.[25] Our 2007 *Arbitration Trap* report documented cases of arbitrators being blackballed by arbitration providers for ruling against their corporate clients,[26] and AAA's annual reports have referred to the corporations that file arbitrations as its "clients and customers."[27] This business-friendly approach is highly profitable. NAF's net income was $10 million in 2006, an astounding 26 percent profit margin on revenue of $39 million.[28]

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[21] *See* Berner & Grow, *supra* ("NAF sells itself to lenders as an effective tool for collecting debts. The point of these pitches is to persuade the companies to use the firm to resolve clashes over delinquent accounts . . . A September, 2007, NAF PowerPoint presentation aimed at creditors and labeled 'confidential' promises 'marked increase in recovery rates over existing collection methods.' At times, NAF does this kind of marketing with the aid of law firms representing the very creditors it's trying to sign up as clients.").

[22] *See id.*

[23] *See* Mike Tomkies and Kathleen Caress, "Jams Revises Procedures On Class Wide Arbitration", *at* http://consumerfinancelawyers.org/CM/Alerts/Jams-Revises-Procedures.asp ("[JAMS] recently revised its class action procedure to make clear that it will enforce a class action waiver provision, or its equivalent, contained in an arbitration agreement unless a court orders the matter or claim to arbitration as a class action. This revision is a reversal of JAMS' prior policy, which was to decide the enforceability of class action waivers on a case-by-case basis in each jurisdiction . . . Following the November 2004 policy change, many creditors removed JAMS as a potential arbitrator from their arbitration provisions. Creditors might once again consider JAMS as a potential arbitration administrator for arbitration clauses with class action waivers as a result of JAMS' latest policy move.").

[24] *See* LAKE RESEARCH PARTNERS, NATIONAL STUDY OF PUBLIC ATTITUDES ON FORCED ARBITRATION 15 (Apr. 2009) (finding that 64 percent of Americans polled cannot remember reading about a forced arbitration provision in Terms of Agreement for goods and services) *at* http://www.fairarbitrationnow.org/uploads/Forced%20Arbitration%20Study%20Slides%200409.pdf.

[25] *See* Sternlight, *supra.*

[26] *See, e.g.,* PUBLIC CITIZEN, THE ARBITRATION TRAP at 30-31 (Describing the case of Harvard law professor Elizabeth Bartholet, who resigned from NAF in February 2005, citing concern for NAF ethics and "its apparent systematic bias in favor of the financial services industry.").

[27] *See* Testimony of Laura MacCleery, Director, Public Citizen's Congress Watch division, before House of Representatives Committee on the Judiciary, Subcommittee on Commercial and Administrative Law, October 25, 2007 at 4.

[28] Berner & Grow, *supra.*

It is difficult to overstate the unfairness of a system that forces consumers to resolve disputes against large corporations in forums that compete to please the corporations.

B. Forced Arbitration Enables and Creates Incentives to Engage in Predatory Practices.

Because arbitration companies are not required to respect the law and often grant creditors' claims based on exceedingly little evidence,[29] forced arbitration enables creditors and debt collectors to pursue invalid, unlawful debts. For example, there is little to prevent an arbitrator from issuing an award on a debt that had passed the statute of limitations, a so-called "zombie debt." Once that award has been obtained, the creditor can secure a judgment in court confirming the award—effectively laundering it into a valid debt. This possibility is deeply troubling when one considers that as much as $100 billion dollars worth of debt purchased in 2008 was "junk debt" that was not actually due.[30] The bulk of zombie debt is from credit cards.[31] Therefore, the original contracts likely contained forced arbitration clauses, a nearly universal practice among credit card issuers, and debt collectors may be pursuing roughly $100 billion of unlawful debt in a forum that has a tendency to rubber-stamp their claims.

Arbitration also makes it easier for debt collectors and creditors to obtain judgments in cases that are disputed, particularly cases that involve mistaken identity or identity theft. Our report examined NAF's credit card arbitrations, finding that corporations beat consumers almost 94 percent of the time. In one of those cases NAF ordered a New Hampshire man, Troy Cornock, to pay MBNA $9,446.85, despite the fact that the man's ex-wife had actually opened the account, and NAF and MBNA had sent all of their correspondence to his ex-wife's address.[32] MBNA presented the arbitrator with no evidence of a credit card agreement or credit card receipt with the alleged borrower's signature on it, but was able to take the arbitration award to court and secure a judgment.[33]

Anastasyia Komarova was living in San Francisco in 2005 when she was notified that NAF had issued an award for $11,214.33 against her for an MBNA account. It turned out that the MBNA account belonged to a woman with a similar first name, and that MBNA was aware of the mix-up, but the debt collector that they hired had proceeded in arbitration and obtained a judgment against her anyway. In response to this and many other California cases, the San Francisco City Attorney has filed suit against NAF and Bank of America for "operating an arbitration mill, churning out arbitration awards in favor of debt collectors and against California

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[29] Berner & Grow, *supra*.
[30] *See Zombie Debt: The Bills That Just Won't Die*, ABC NEWS, Feb. 28, 2008, http://abcnews.go.com/GMA/Story?id=4358702&page=1.
[31] *See* Eileen Ambrose, *Debt Can Come Back to Haunt You Years Later*, BALTIMORE SUN, May 6, 2007.
[32] *See* PUBLIC CITIZEN, THE ARBITRATION TRAP at 11-12.
[33] *Id.*

consumers."[34] According to the City Attorney's office, the case is in the discovery phase and litigation is progressing slowly. NAF has asserted arbitral immunity from any lawsuits, a doctrine that ordinarily immunizes arbitrators from claims by the parties to the arbitration. Bank of America has asserted the defense that all local consumer protection actions against banks—including this suit involving only arbitration and no banking laws—are preempted by the Office of the Comptroller of Currency's exclusive oversight authority of federally chartered banks under the National Bank Act.[35]

C. Forced Arbitration Undermines Existing Law and Stymies the Development of the Law.

Prior to 1985, statutory causes of action reflecting "important public policies" were exempt from mandatory arbitration.[36] A series of Supreme Court decisions from 1985 to 1991 reversed that rule.[37] Important legal protections are now undermined because they are subject to forced arbitration—before arbitrators who are not required to follow the law. Consumer lending laws like the Truth in Lending Act (TILA), Fair Credit Reporting Act, Fair Debt Collection Practices Act (FDCPA), Equal Credit Opportunity Act (ECOA), and Credit Repair Organizations Act (CROA) are all subject to arbitration, leaving them vulnerable to under-enforcement. Future consumer protection and reform efforts will also be undermined by forced arbitration. For example, the valuable reforms in the Credit Cardholders' Bill of Rights, sponsored by Rep. Carolyn Maloney and Sens. Charles Schumer and Tom Udall, amend TILA. The provisions of this bill might be skirted or ignored by lenders, and consumers who are subjected to arbitration will have virtually no recourse against these violations.

Forced arbitration also hampers the development of the law. The secretive nature of arbitration, including the lack of a written opinion explaining the arbitrator's interpretation of the law and its application to particular facts, undermines the benefits of transparent public court hearings. Open litigation serves important functions such as educating the educating the public about potential harms and providing a record of how the law is being interpreted and applied. Without this process, the Congress has little way of assessing how laws are applied and whether improvements are needed. The public also loses the benefit of learning facts that might spur political or legal reforms.[38]

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[34] Sam Zuckerman, *S.F. Sues Credit Card Service, Alleging Bias*, S.F. CHRONICLE, Apr. 8, 2008 at D-1.
[35] *See* 12 C.F.R. § 7.4000.
[36] David S. Schwartz, *If You Love Arbitration, Set It Free*, 8 NEV. L.J. at 406.
[37] *Id.*
[38] *See* Jean R. Sternlight, *Creeping Mandatory Arbitration: Is It Just?*, 57 STAN. L. REV. 1631, 1662-63 (2005).

III. Forced Arbitration Proponents Have Failed to Demonstrate That Forced Arbitration Benefits Consumers.

A. In Forced Arbitration, Consumers Win Less Frequently and Are Awarded Less of What They Seek Than Businesses.

The claim that arbitration is better and fairer for consumers than bringing claims before a judge or jury rings hollow when it comes from the same credit card companies that invented practices like universal default and "any time, any reason" interest rate increases. That these firms would look out for consumers' best interests regarding the justice system is simply not credible.

It also defies the evidence. There is no empirical evidence to support the conclusion that individual plaintiffs fare better in arbitration than they do in court. Our 2007 Arbitration Trap report found that consumers lose an astounding 94 percent of credit card arbitrations before NAF.[39] A number of industry-backed studies have attempted to refute these findings, however, each of these studies largely suffers from the same three shortcomings: over-counting consumer "victories"; unreliably small sample size; and complete lack of verifiability.[40]

The Searle Center study conducted by Professor Drahozal has been touted as strong, cutting-edge, empirical evidence that arbitration is fair. But there is nothing new about this study or its findings. First, the study focuses on AAA, which as been a focus of most industry studies of arbitration.[41] One obvious shortcoming is that AAA handles relatively few consumer cases,[42] with banks and other lenders preferring the services of the notorious "arbitration mill" NAF. Traditionally, AAA has handled more employment disputes and contractual fights between companies;[43] therefore it is hardly representative of the entire arbitration industry.

The Searle Center study is also similar to earlier industry-supported studies because its overly broad conclusion that arbitration is good for consumers is simply not supported by its own findings.[44] The Searle Center study found that consumers received an award in 53 percent of the cases they initiated and received about 52 percent of the amount they sought in those cases.[45] Businesses received an award in 84 percent of cases they brought and won 93 percent of what they asked for in those cases.[46] This means that businesses received roughly 78 percent of what they

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[39] *See* PUBLIC CITIZEN, THE ARBITRATION TRAP at 4.
[40] *See generally*, PUBLIC CITIZEN, THE ARBITRATION DEBATE TRAP 8-12 (2008) *at* www.citizen.org/publications/release.cfm?ID=7589&secID=1052&catID=126.
[41] *See* David S. Schwartz, *Mandatory Arbitration and Fairness*, 84 NOTRE DAME L. REV. 101, 135-36 (2009).
[42] *See* Berner & Grow, *supra* ("[AAA] says it handled 8,358 consumer arbitration cases in 2007.").
[43] *Id.*
[44] *See* PUBLIC CITIZEN, THE ARBITRATION DEBATE TRAP at 13-23.
[45] *See* SEARLE CIVIL JUSTICE INSTITUTE, CONSUMER ARBITRATION BEFORE THE AMERICAN ARBITRATION ASSOCIATION 109 (2009) *at* http://www.searlearbitration.org/p/full_report.pdf.
[46] *Id.*

sought compared to 28 percent for consumers. Both in success rates and award amounts, AAA arbitrations appear to be heavily slanted in favor of businesses.

We are also concerned about the study's reliance on data that comes only from the company, and is not publicly available. In a report that we released last year, Public Citizen attempted to duplicate AAA's 2007 findings that individuals prevailed in 48 percent of consumer-initiated arbitrations by analyzing reports it published as required under California law.[47] Unfortunately, we could discern the victorious party only in approximately 7 percent of the cases.[48] AAA left the "prevailing party" field—a required disclosure—blank in more than 90 percent of the cases it had reported.[49]

Recently, we analyzed AAA's disclosures to the state of California again, examining just over 61,000 cases reported since 2004. Of these, more than 45,000 since September 2007 were filed by Midland Credit Management, a Kansas-based collection agency. AAA arbitrators have provided Midland the precise amount sought—to the penny—in 87 percent of the cases in which they have issued a ruling. Overall, AAA has given Midland more than 94 percent of the amounts it has sought. Midland is notorious for aggressive collection tactics,[50] making it highly unlikely that its claims are consistently fair and accurate.

NAF arbitrators also award creditors nearly all that they request.[51] One former NAF arbitrator reported that NAF provided him with an award form with the amount sought by the creditor already filled in.[52] Arbitration companies also routinely award exorbitant attorney's fees in their collection cases. In one case concerning an alleged debt of $29,000, the debt collector sought "reasonably anticipated" attorney fees of about $11,000—about one-third of the underlying debt. The NAF arbitrator awarded the collector a total of $45,773 based on no evidence other than what was provided by the debt collector. In another case, NAF

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[47] PUBLIC CITIZEN, THE ARBITRATION DEBATE TRAP at 12.
[48] *Id.*
[49] *Id.*
[50] *See, e.g., Martinez V. Midland Credit Management, Inc.*, 250 S.W.3d 481 (Tex.App.-El Paso 2008). In this case, Midland sought $2,077 from a woman named Marina Martinez for a purported debt of hers that it had purchased. After a trial court granted summary judgment in Midland's favor, a Texas appeals court found that Midland had not indicated "in any way" that it had knowledge of the record-keeping policies of the predecessor businesses from which it had purchased the debt. The appeals court ruled that "Midland offered no admissible evidence concerning its claim" and dismissed the trial court's ruling. In another case, *Wahl v. Midland Credit Management, Inc.*, 556 F.3d 643 (7th Cir. 2009), Midland tried to collect $1,149 on a stroke victim's credit card account for a card that had not been used since its balance stood at $66.98. In fact, the card issuer had been so zealous in applying interest and fees that it pushed the card's amount due from $66.98 to nearly $1,000 in just four years. After Midland acquired the debt, it claimed that all $1,149 was "principal" because that is where the debt stood when Midland took possession.
[51] *See* PUBLIC CITIZEN, ARBITRATION TRAP at 23 (documenting the case of NAF arbitrator Steven Bromberg, who considered 77 cases on two selected days, and awarded creditors 96.7 percent of the total amount requested).
[52] Berner & Grow, *supra*.

awarded "attorneys fees" of $10,631.62 on an alleged debt of $25,798.16. NAF awarded the full amount of fees, despite the fact that the debt collector's request form was signed by an "arbitration manager," not an attorney. Attorney's fees of 33 percent are extraordinary for a process that requires no actual attorney work or documentation and is routinely touted as fast, cheap, and easily navigable without representation. With arbitration firms like NAF, and now apparently AAA, routinely awarding them the full amount that they request, with no questions asked, creditors and debt collectors have scant incentive to treat consumers fairly. In fact, they have every incentive to gouge consumers, even making illegal claims.

B. Forced Arbitration Reduces Access to Justice.

Arbitration is harmful to consumers because it reduces access to justice. The argument that it provides people greater access to justice is appealing, but there is no evidence that one could present to either prove or disprove the point. The win rates and reduced award amounts mentioned above do not measure the number of Americans who are deterred from bringing claims in the first place. Any consumer who consults with a lawyer prior to arbitration will be told that they will face almost insurmountable odds in arbitration. No lawyer can, in good conscience, accept a case that they know to be stacked against consumers, and few consumers pursue claims that legal experts have told them are hopeless.

The blanket argument that all litigation is costly for the individual is misleading. Many small claims filing fees are quite low. Many federal statutes also provide for attorneys fees, making it possible for individuals to pay for counsel and bring claims when they would not otherwise be able to.[53]

The pricing scheme of arbitration also hinders individuals' ability to bring claims. Neither the company nor the arbitration provider has any incentive to make arbitration cheap or easy. Customers who are angry enough to take a company to court or arbitration are unlikely to give repeat business to that company, so the company has no reason to cater to their needs. Arbitration companies seeking repeat business actually have an incentive to charge *higher* prices to satisfy the corporations that write them into form contracts.[54] Competitive arbitration pricing is an anathema to the primary purpose of arbitration provisions for large corporations, which is stopping any form of dispute resolution.[55] Since large

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[53] *E.g.*, Civil Rights Act of 1964, 42 U.S.C. § 2000e-5(g)(2)(B)(i); Fair Debt Collection Practices Act, 15 U.S.C. § 1692k(a)(3).
[54] *See* Cary Ichter, *The Special Master Solution To The Hall Street Blues: The Use Of Special Masters As An Alternative To Arbitration*, METRO. CORPORATE COUNSEL, Jan. 2009 at 15 ("Dispute resolution providers have little interest in introducing competitive pricing or any other mechanism to reduce transactional costs of dispute resolution because their principle business sources—the companies that write the arbitration clauses—benefit from higher transactional costs. The higher the transactional cost of arbitration, the lower the probability that arbitration claims will be asserted against them.").
[55] *See id.*

companies can easily afford any costs that they might be forced to pay, the high-priced fee structure of arbitration only serves to deter individual lawsuits.

Our 2007 report compared the costs, excluding attorneys fees, associated with an arbitration proceeding and a court case involving the same issues and the same termite company. The parties in arbitration incurred $24,000 in costs, as compared to $563 paid by the party who took her claim to court. In securities arbitration, securities firms use costly motions to dismiss against individual investors. The Financial Industry Regulatory Authority (FINRA), the private securities regulatory body, recently placed a limit on the number of motions to dismiss that a party can file, in order to prevent companies from repeatedly filing such motions to run up arbitration costs.[56] The pricing structure of arbitration is clearly structured to favor large businesses over individuals.

Unreasonable arbitration fee structures can be particularly useful to manufacturers of low-cost consumer products. Take the example of the computer manufacturer Gateway, whose arbitration clause employed a fee schedule that required a $2,000 nonrefundable up-front payment plus a loser-pays requirement for the prevailing parties filing fee and attorneys fees.[57] Under this "heads I win, tails you lose" structure, a consumer with a defective computer would have to pay $2,000 *even if successful*, and at least $4,000 (plus attorneys fees) in the event that they lost. Since most computers cost less than $2,000, it's hard to imagine a scenario in which consumers would have an incentive to participate in arbitration.

The cost of arbitration is less important in some cases. Certain high-probability, low-magnitude harms, like overcharging fees on credit cards and other consumer products,[58] can be challenged only through consumer class actions.[59] In industries where these high-probability, low-magnitude harms are more likely to occur, arbitration clauses often provide that the corporation will pay all or part of the arbitration fees, but include a prohibition on consumer class actions. Companies include the fee provision to make the class action ban appear reasonable.[60] By banning class actions, consumer service providers, like credit card companies, deter

[56] *See* Suzanne Barlyn, *SEC OKs Changes to Motion-To-Dismiss Rule*, WALL STREET J., Jan. 8, 2009 ("Finra has received complaints that parties—most often securities firms—were filing dispositive motions routinely and repetitively, causing increased costs for claimants, who are typically retail investors, according to a statement.").

[57] *See* Jeff Sovern, *Toward a New Model of Consumer Protection: The Problem of Inflated Transaction Costs*, 47 WM. & MARY L. REV. 1635, 1649-50 (2006) (citing *Brower v. Gateway 2000, Inc.*, 246 A.D.2d 246 (1998)).

[58] *See* Bar-Gill & Warren, *supra*, at 77; *see also Ross v. Bank of America, N.A*, 524 F.3d at 224 (2008) ("[A]ctions that result in significant aggregate revenue to the banks (concerning, e.g., late fees, overlimit fees, foreign transaction fees, APR, etc.) generally harm individual consumers in only small amounts[.]")

[59] *See Scott v. Cingular Wireless*, 161 P.3d 1000, 1005 (Wash. 2007) ("As we have noted before, when consumer claims are small but numerous, a class-based remedy is the only effective method to vindicate the public's rights.").

[60] *See* P. Christine Deruelle & Robert Clayton Roesch, *Gaming the Rigged Class Arbitration Game: How We Got Here and Where We Go Now—Part II*, METRO. CORPORATE COUNSEL Sept. 2007 at 5.

consumers from bringing claims that are feasible only if brought on a class basis.[61] They have effectively immunized themselves because, as Judge Richard Posner has said, "[t]he *realistic* alternative to a class action is not 17 million individual suits, but zero individual suits, as only a lunatic or a fanatic sues for $30."[62]

The disincentives to arbitrate must be strong because consumers rarely file arbitration claims. Between 1998 and 2000 only four consumers filed arbitration claims against the credit card company First USA, compared to 51,622 arbitration claims filed by First USA against its consumers.[63] Our 2007 report found that consumer brought only 118 claims out of 33,948 credit card arbitrations before the NAF between 2003 and 2007.[64] The number of consumer claims is likely to decrease even further as the economy continues to sour and the cost becomes even more prohibitive.

C. Forced Arbitration's Purported Speed Is of Little Value to Consumers, and Arbitration May in Fact Be Slower than Court.

Forced arbitration proponents argue that arbitration is faster for consumers than court. This speed harms consumers when arbitrators act as nothing more than a rubber stamp for companies and consider around forty cases in one day.[65] NAF boasts to its corporate clients that the procedural "flexibility" of arbitration can be used to their advantage, advising them that they may request stays and dismissals of actions to "control process and timeline."[66] None of this provides efficiency benefits to consumers.

Moreover, there is some reason to believe that the arbitration process may take longer than court proceedings. Industry arbitration studies routinely count settlements and dismissals in arbitration to pad the supposedly consumer-friendly

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[61] *See* Bar-Gill & Warren, *supra*, at 78 ("The widespread inclusion of arbitration clauses in standard credit card contracts inoculates lenders against the possibility of class action lawsuits, which would otherwise change the economics of pursuing debtor's rights."); *see also Scott*, 161 P.3d at 1007-08 ("We . . . conclude that since this clause bars any class action, in arbitration or without, it functions to exculpate the drafter from liability for a broad range of undefined wrongful conduct, including potentially intentional wrongful conduct[.]"). Ironically, consumer service providers actually disfavor arbitration when it is conducted on a class basis. *See* Eisenberg, Miller & Sherwin, *supra*, at 884 (finding that 60 percent of consumer contracts that contained mandatory arbitration clauses voided the arbitration clause if the arbitration process allowed for classwide activity); *see also* Christine Deruelle & Robert Clayton Roesch, *Gaming the Rigged Class Arbitration Game: How We Got Here and Where We Go Now—Part I*, METRO. CORPORATE COUNSEL Aug. 2007 at 9 ("Recent developments in class arbitration law have left 'defendants with the worst of all worlds—the threat of a class action in a forum without the procedural, evidentiary and appellate protections available through the judicial process.'").

[62] *Carnegie v. Household Int'l, Inc.*, 376 F.3d 656, 661 (7th Cir. 2004).

[63] Sternlight, *supra*, note 8, at 1655.

[64] PUBLIC CITIZEN, ARBITRATION TRAP at 15.

[65] *See id.* at 23 (documenting the case of NAF arbitrator Steven Bromberg, who considered 77 cases on two selected days, finding for credit card company MBNA in 76 of those cases).

[66] Berner & Grow, *supra*.

outcomes.[67] But industry studies comparing case lengths omit settlements and dismissals in litigation.[68] Settlements and dismissals are final dispositions, and they should be counted along with cases resolved at trial. Additionally, one study simply excluded the arbitrations that were longest in duration: a 2003 study of 998 AAA employment arbitrations filed in 1999-2000 omitted the 632 arbitrations that were decided after 2000.[69] Essentially, this study removed all of the slowest cases because they were taking too long, and only measured the fastest third of the cases. When one considers all of the cases that are filed and all of the venues in which they are filed, such as small claims courts and administrative bodies, there is reason to believe that non-arbitral forums may actually be quicker than arbitration.[70]

D. Arbitration Raises Costs for Consumers Rather Than Lowering Them.

Many businesses argue that they will be forced to impose additional costs on consumers if Congress curbs forced arbitration. But during the period when forced arbitration proliferated throughout the credit card industry, fees and interest rates only increased.[71] Moreover, consumer class actions, which forced arbitration prevents, have demonstrably reduced costs for consumers by forcing credit card issuers to reduce fees.[72]

We have seen arguments like this one before, in which businesses have argued that a so-called "tort reform" measure—and forced arbitration is undeniably a "tort reform" mechanism—would result in reduced costs for goods and services.[73] They were wrong then as well. For example, sponsors of several "tort reform" bills in Texas in the late 1990s alleged that the legislation saved consumers and businesses $3 billion in insurance premiums.[74] Data actually shows that insurance premiums were not significantly reduced by the legislation, and insurance companies' profits increased due to a $600 million reduction in costs from a combination of the legislation, safer driving, and safer cars.[75] The Congressional Budget Office has estimated that other proposed medical tort reform measures would have a negligible impact on medical costs.[76] The same report found that

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[67] *See* PUBLIC CITIZEN, THE ARBITRATION DEBATE TRAP at 13-23.
[68] David S. Schwartz, *Mandatory Arbitration and Fairness*, 84 NOTRE DAME L. REV. at 163.
[69] *Id.* at 164.
[70] *Id.* at 164-65.
[71] *See supra* § I.
[72] *See* Public Citizen, *Six Common Transactions That Cost Less Because of Class Actions* (Aug. 30, 2003), at http://www.citizen.org/congress/civjus/archive/classaction/articles.cfm?ID=10278.
[73] *See, e.g.,* Letter from Bruce R. Josten, Executive Vice President, United States Chamber of Commerce, to United States Senate in Support of the Class Action Fairness Act, July 6, 2004 at http://www.uschamber.com/issues/letters/2004/040706classactionfairness.htm ("This legislation is needed because of the significant increase in national class action lawsuits filed in state courts . . . have significant adverse effects on our economy such as higher prices for goods and services[.]").
[74] *See* Richard A. Oppel Jr. & Jim Yardley, *Bush Calls Himself Reformer; the Record Shows the Label May Be a Stretch*, NY TIMES, Mar. 20, 2000, at A16.
[75] *See id.*
[76] *See* CONG. BUDGET OFFICE, LIMITING TORT LIABILITY FOR MEDICAL MALPRACTICE 6 (2004) ("Malpractice costs amounted to an estimated $24 billion in 2002, but that figure represents less than 2 percent of

"many reported reductions in supply by health care providers could not be substantiated or 'did not widely affect access to health care.'"[77] These experiences cast doubt on the reliability of claims that prohibiting forced arbitration in consumer contracts would raise consumer costs.

Arbitration is cheaper for one group: businesses. The problem for Americans is that they can't afford not to fight back against predatory practices, but they also can't afford to go to arbitration. Between high costs, bans on consumer class actions, and pro-corporate bias, there is no justice in the fine print for individuals when an arbitration clause is included in their credit card contracts.

III. The Solution: Ban Forced Arbitration.

Advocates of forced arbitration paint advocates of voluntary consumer arbitration as "anti-arbitration." This is simply not the case. We object to the unfair practice of *forcing* people into arbitration as a condition for service, before any dispute has arisen. We support the Arbitration Fairness Act, sponsored by Representative Hank Johnson and Senator Russ Feingold,[78] which would give consumers a meaningful choice between going to arbitration or court. Industry-funded studies that attempt to show benefits of forced arbitration are deeply flawed, and they are a distraction. Common sense says that forced arbitration is unfair. If a particular type of arbitration were truly good for consumers, then corporations shouldn't have to force it on them.

Indeed, prohibiting corporations from forcing consumers into arbitration is a market-based solution: When consumers can choose whether to arbitrate, and where, arbitration companies must compete for their business. When arbitration is post-dispute—and therefore *voluntary*—arbitration companies must offer a fair process that both parties would choose willingly.

overall health care spending. Thus, even a reduction of 25 percent to 30 percent in malpractice costs would lower health care costs by only about 0.4 percent to 0.5 percent, and the likely effect on health insurance premiums would be comparably small.").

[77] *Id.* at 7.

[78] H.R. 1020; S. 931.

Mr. COHEN. We will now begin the questioning, and I will begin by recognizing myself for 5 minutes.

Mr. Donovan, in your prepared statement for this hearing you offer several recommendations for Congress to consider to protect credit cardholders. One of these is no mandatory arbitration either for consumer claims or for collection against consumers. Why do you suggest that and how has the credit card industry used mandatory arbitration which would lead you to this recommendation?

Mr. DONOVAN. Thank you for your question, Mr. Chairman.

Three reasons I suggest that. First, this Congress has wisely looked at the exact same question with regard to credit extended to our service members. This Congress has wisely determined that for credit extended to our service members you should outlaw arbitration because the process, as portrayed and exercised with regard to service member credit, is unfair and it is unwise to force service members to go through biased arbitration.

This Congress has also looked at the exact same question when it came to car dealers dealing with car manufacturers, franchisees dealing with franchisors. This Congress has looked and said, look, a car dealer is a smaller operation. It is usually a mom and pop, a small business operation, and it cannot defend itself or fight off mammoth car manufacturers who dictate what the terms of the franchise agreement is going to be. So this Congress wisely, I believe, Republicans and Democrats alike, have determined that you should outlaw arbitration between car dealers and car manufacturers.

What are the bases of those two decisions? The bases of those two decisions is that this Congress determined that arbitration is unfair when you use—when the stronger party has an unfair advantage over the weaker party.

The second point, arbitration is doubly unfair when you are talking about small claims. The claims involving credit cards are ordinarily claims relating to payment processing practices, late fees, over limit fees, or a misapplication of payments for an unfair change in terms.

Those are generally small cases, generally not in excess of a couple of hundred dollars at most. Almost no consumer can find a lawyer or has any wherewithal or ability to map themselves through an unfamiliar arbitration process. So what you need is you need a system in which you have lawyers and advocates who are able to weed through the good from the bad cases and bring the good cases and not pursue the bad cases, and what happens is the class action does that.

Third reason, merchants are also subjected to arbitration clauses. Mr. Issa pointed out that he was a business owner. The business owners here have also been subjected to unfair arbitration clauses. Merchants have agreements with all the credit card issuers.

In fact, one of the biggest class action plaintiffs in the bigger credit card class actions in the United States was Wal-Mart stores. It was a representative plaintiff in a class action. It brought that class action and settled it for $3 billion. That is a major manufacturer that will now be exposed to unfair arbitration terms foisted upon it by the credit card industry because it is going to be forced to pay unfair merchant fees that can change at any time.

So not only do ordinary consumers need the Arbitration Fairness Act to be enacted, but also every entrepreneurial decent business in the United States needs the Arbitration Fairness Act to be adopted and changed.

Thank you.

Mr. COHEN. Thank you, sir.

Professor Frankel, are there alternatives to mandatory binding arbitration less than the bill that are under consideration that you think might be offered that would be fair to consumers and businesses both?

Mr. FRANKEL. One alternative that I think is a good alternative is the one proposed in the Arbitration Fairness Act which would make post-dispute, voluntarily agreed to arbitration where both parties, after the dispute, decide they want to arbitrate. That is one alternative. That creates an opportunity for greater fairness, for not having specific terms foisted upon it. That really is a voluntary agreement.

And I think there is a big difference, as you can tell from I think most companies' own behavior, that they see a big difference between voluntary arbitration and forced arbitration. Most companies that negotiate arm's-length contracts with other companies don't put arbitration clauses into these contracts. Where they do use arbitration clauses is in where they have a chance to do it unilaterally against consumers.

Mr. COHEN. Thank you. My time has expired; and I now yield to the Ranking Member, Mr. Franks, for questions.

Mr. FRANKS. Well, thank you, Mr. Chairman.

Professor Drahozal, the second phase of the study that you have been working on will specifically examine the relative merits and demerits of arbitration and class actions. That is kind of the bottom line for the specific topic of today's hearing. When do you expect your study to be complete, and what specific questions will you research?

Mr. DRAHOZAL. Well, the important part of the second phase will be looking at how our results compare to other comparable cases in the court system. You can't really evaluate whether something is fair on its face simply by looking at what happens in arbitration. So what you have to look at is how it, arbitration, compares to other court cases.

I was actually doing some preliminary reading on that question. Which we have a while to go, unfortunately, before we will have final resolution. But I came across a study that found that corporations won 90 percent of their claims against individuals, and individuals won 50 percent of their claims against corporations, which looks a lot like our results from arbitration.

What was interesting is that was a study of Federal court diversity cases, which are large claims, not in arbitration. And you get very similar results. Now, we will focus on sort of comparable claims, which typically are smaller claims, but I sort of anticipate finding similar sorts of things.

Other aspects of what we will do in the second phase will be, as you say, look at the extent to which class actions are potential substitutes or comparable cases for arbitration claims. Presumably looking at the cases that, as Mr. Arkush pointed out, were after the time period that we were studying in the initial phase. I wish I could promise a date by which that will be done. My dream date is realistically the end of the year. I mean, this is sort of very intense data collection and then writing. We will have to see.

I had the benefit this year of being on sabbatical to do the first phase. I will be back teaching next semester and will have competing demands on my time. That is my hope.

Mr. FRANKS. Well, thank you.

I suppose, just from a common sense perspective, that doesn't surprise me a great deal, you know, that businesses, before they go after one of their customers, they are going to probably want to have a pretty strong case; and that they would win 90 percent of those doesn't surprise me at all. So what you say makes sense.

I guess my concern is that if we put this where class actions are the main—you know, the main mechanism for solving these things, it is a little like the old statement that, you know, a lot of times lawyers challenge two people to strip for a fight and then they steal their clothes. And it is a difficult situation to deal with.

So let me ask you, how do you answer Public Citizens' criticism, Mr. Arkush's criticisms there of your study? How do you respond to that?

I want to give you an opportunity because he took your name in vain in some pretty significant ways there.

Mr. DRAHOZAL. Mostly, it was a sort of fair debate, I would say. I do not feel slandered in any way, shape or form.

The main response, again, is to some extent the one I just gave, which is—well, first of all, it seems to me the AAA results—while I agree that that is one provider out of several—are certainly relevant to the debate. We cannot focus on just one provider, like the National Arbitration Forum to the exclusion of others.

What is interesting about the AAA consumer database or consumer claims is, in our sample, there was a much higher proportion of claims brought by consumers. So, if we really want to see how consumers do when they bring claims, we really need to look at not just the NAF, but also at the AAA, which is what we are able to do.

The second point is the second phase of the study, that to really understand what our results mean from the first phase, we cannot just look at the numbers and say 90 percent is bad, and that is all we need to know; we need to have something to compare it to.

Mr. FRANKS. Do you have any methodological or other flaws that you would point out or opine resulted to Public Citizen study of the credit card arbitration in California?

Mr. DRAHOZAL. Well, there certainly are some disputes, and I have not studied the NAF in the same way that I have studied the American Arbitration Association, so I cannot sort of talk about what exactly the practices are.

Looking at the empirical results, there is a dispute about how you treat settlements, for example. I mean settlements benefit the consumer, so they should be seen as sort of a, quote/unquote, "win" for the consumer.

My main comment on Public Citizen's study is the interpretation of the data, and again, it is the same point: Even if businesses win 90-plus percent of the time, that does not necessary mean the process is unfair. Again, this is part of what we are going to be doing in the next phase of the study, but if you look at studies of small claims courts, which involve business debt collection, it looks amazingly like the way the Public Citizen describes the NAF arbitration. Businesses almost always win; the consumers almost never show up. So this is not a problem with arbitration.

Again, we may find out differently in the next phase, and so to that extent, I reserve judgment; but from what I have seen so far, the problem is not with arbitration. There may be issues with debt collection—I mean, if consumers, in fact, owe the money, it is not surprising they do not show up, for example. So I think a lot of this has to do with the type of claim rather than the process that is involved.

Mr. FRANKS. Mr. Chairman, the light is red. Thank you.

Mr. COHEN. Thank you, Mr. Franks.

I now recognize the distinguished vice Chairman from the Bay State and former prosecutor, Mr. Delahunt.

Mr. DELAHUNT. Well, thank you, Mr. Chairman, for that rather generous introduction.

I just have one question, and I apologize for being tardy, but we always hear how different approaches will save the consumer money. For example, arbitration will lower the litigation cost, and that is, as a result, a savings that is passed on to the consumer.

Is there any data to support that, Mr. Arkush, or is that just simply, you know, credit card industry-speak?

Mr. ARKUSH. If it is not nothing more than credit card industry-speak, it is barely more. I mean, we have seen no data to support that claim, and in fact, there are plenty of data points that indicate the opposite.

During this same period of time when arbitration—when the practice of forced arbitration proliferated throughout the credit card industry, the industry was raising fees and raising penalty interests, basically erecting all of the tricks and traps that that industry now uses. And the full House of Representatives just acted to ban some of those practices this past week.

Mr. DELAHUNT. Professor Frankel.

Mr. FRANKEL. I agree. The only thing that I would add is that, in some way, you could actually perceive it as raising costs on the consumer because the consumer's credit card, to some extent, is less valuable. The more time that they have to spend monitoring credit card companies because they do not have litigation as a forum, the more care they have to take. So it reduces the value of their card at the same time that credit card companies are charging the same price.

Mr. DELAHUNT. Professor Drahozal.

Mr. DRAHOZAL. I would love to be able to do that study. It is really difficult to do.

The way that I think about this issue is: What would happen if arbitration—if credit card companies could not use arbitration? My prediction would be that prices would probably go up, that interest rates would go up; and what that suggests to me is, by using arbitration, implicitly the interest rates have gone down.

Again, that is in just sort of a rough sense. I cannot cite empirical studies.

Mr. DELAHUNT. Right. There is no data.

I remember during the hearings that we had on the so-called "bankruptcy reform act" that we were told that an average family would save somewhere in the neighborhood of $400 a year if we passed that particular legislation.

I have not seen that kind of savings, have you, Mr. Arkush?

Mr. ARKUSH. No, we have seen nothing like it. In fact, we get these types of claims repeatedly on not just bankruptcy issues, but on any sort of so-called "reform" of the justice system. You frequently see claims that costs will be passed on to consumers, and they are never—as far as I can tell, they have never been borne out by the evidence.

In fact, what we can really expect is restoring a robust system of accountability and liability for bad practices. That is what would reduce costs for consumers.

Mr. DELAHUNT. Mr. Donovan.

Mr. DONOVAN. Congressman, let me build on that very point.

We have to understand that the credit card industry, much like the subprime lending industry, is structured based upon a securitization product. Almost all of the credit card receivables are securitized. To the extent that the investment community does not have confidence in that securitized product because people are using arbitration to hide their bad practices, that increases costs. It increases expenses. It increases credit throughout the United States.

The industry right now has used arbitration falsely, in a lie, to say costs will go down when, in fact, costs will go up directly because of arbitration, because it hides material information from investors as well as from consumers. And there is no doubt that it hides material information; the whole idea of arbitration is to be secret so that nobody else catches on to the fact that you are committing bad practices.

Mr. DELAHUNT. I can remember this one statistic, and I think it occurred maybe in the late 1980's-early 1990's, where the Federal funds rate went down to about 3 percent, and yet the average interest rate of a credit card was around 14 percent. It did not go down. It never seems to go down. There never seems to be a savings for the consumer.

Now, I can understand that, you know, there is a marketplace, but when the marketplace is—really, the construct of the marketplace is, at best, an adhesion contract. And it does not just stop there, because it is not just the individual consumer who is hurt. What we saw with subprime lending was that an entire global economy is put at risk. So, if we do not address these issues from a public policy perspective, we put the free marketplace at risk.

Does anyone want to comment on that?

Mr. DONOVAN. I just want to second that. I think that is exactly right.

The reality of it is that the securitization product here is out there, and it is trading now. To the extent that there are issuers who are engaged in bad practices and those things are disclosed, that securitization product then plummets. That requires banks to increase their reserves, that requires investors to buy credit default swaps, and that increases the direct costs that the banks—and we see this evidenced right now. Every one of the banks in the United States is now increasing their fees on credit card consumers, and they are doing that because they know that they have now been caught and that they have to increase their reserves.

So arbitration will permit them to continue that bad practice in order—and then when it finally comes to the fore, the securitizations will fall, and that will undermine another part of the credit market that we already saw undermined with the subprime lending market. So, to support the free market system, one should outlaw arbitration.

Mr. DELAHUNT. Mr. Chairman, I thank you for the time. And I think that Mr. Donovan speaks with a sense of urgency, and I would hope that Mr. Johnson's bill might be considered for a mark-up in this particular Subcommittee.

With that, I yield back.

Mr. COHEN. Thank you, Mr. Delahunt.

I now recognize Mr. Coble from the State of North Carolina, whose national champions are being honored today on the House floor.

Mr. COBLE. Thank you for that unsolicited endorsement, Mr. Chairman. I appreciate that.

The Jay Hawker may not like that idea, though.

Mr. DRAHOZAL. Yes. We can talk about that afterwards.

Mr. COBLE. Professor Drahozal, in my opening comments, I indicated some thought that maybe these arbitration matters are biased, either on the one hand to the benefit of the credit card companies, or on the other hand to the benefit of the consumers. Any kind of comment on that?

Mr. DRAHOZAL. Certainly, in the study that we did—I mean, a sort of common concern, which has been expressed by various members on the panel and by the Committee, is the idea that arbitration may favor repeat businesses over nonrepeat businesses. The study that—there have been a number of studies looking at that type of bias of the arbitration process. Typically, what we have find is, under some measures of repeat businesses, there was no evidence, there was no statistically significant evidence of any sort of bias or of any difference in result.

With other measures, we found some evidence that repeat businesses fare better than nonrepeat businesses, but the reason for that was that the repeat businesses were more sophisticated at handling disputes, that the evidence suggested that they tend to settle disputes more readily than nonrepeat businesses, and they settle the strong claims against them, which means what is left to litigate are the weaker claims such that they then tend to do better. But it is not evidence of bias; that it is really just evidence of different claims-handling practices.

Mr. COBLE. I thank you, sir.

Professor Frankel, do you have any empirical or supported reason to believe that the State courts would be able to provide trials to the countless single plaintiff or class action plaintiffs who will show up on their doorsteps if the credit card and other consumer arbitration are eliminated? Any idea on that one way or another?

Mr. FRANKEL. Let me make sure I understand your question correctly.

I think, if consumers were allowed to go to court, there might be class act—there might be some class actions that proceed in State courts; and I think State courts are perfectly qualified—that State court judges are perfectly capable of handling those class actions.

Mr. COBLE. I am concerned that perhaps a plaintiff may not be entitled to a class action. He may not be able—Mr. Donovan, do you want to weigh in on this either way?

Mr. DONOVAN. Congressman, I think I understand your question, and that is, if you have an individual case that is unique and that is not suitable for a class case—and there are thousands and thousands of those. The reality of it is that those individual cases are almost always filed very quickly in small claims courts, small claims courts handle them. And almost always the credit card issuers will settle those fairly quickly because they do not want to hire counsel to appear in small claims courts; and you get them resolved.

By contrast, Congressman, with the National Arbitration Forum specified in the contract, the credit card companies uniformly refuse to settle. Why? Because they own that forum, that is why. That is why they put it in the contract, and they will fight those cases.

So what happens is, arbitration prevents settlement, it prevents dispute resolution, and it is, in fact, counterproductive at least in the credit card contract.

Now, for class cases, you know, class cases are unique. You need a common question, a common, uniform practice. They are particularly suitable in the credit card industry because it is almost all computer program. If it happens to one, it happens to all the credit cardholders; and they are particularly suitable for payment processing problems.

I think I discussed one of the biggest things, and I am sure your constituents have this problem; they say, “Hey, I sent the payment in 2 weeks ago.” They did not credit it, and they imposed a late fee on me. Well, what is happening is, many times, these credit card companies will change the P.O. Box address where you are supposed to send the payment without telling anyone, and yet they impose the late payment still.

Guess what? Anybody can complain. They could say, “Hey, look, you never told us that the P.O. Box has been changed; you should credit me the late payment.” They say, “No, we are not crediting you a late payment.” What do you need? You need a class action.

Mr. COBLE. My time is about to expire, Mr. Donovan. Let me extend this to Mr. Arkush.

Mr. Arkush, I have generally the same question: If we eliminate mandatory binding arbitration, it seems to me the hordes of credit card customers will either not qualify for class action, as we just indicated, or will not be able to afford counsel in their individual cases; and if I am on the right track, these people may well be denied justice.

What does Public Citizen say about this?

Mr. ARKUSH. If we have a well-functioning small claims system, then people can go there without being able to afford counsel. Those same people you are describing right now are getting no justice from forced arbitration. As I said, in 34,000 NAF cases, only 118 were brought by consumers.

The other thing that is important to realize here, I think, is that an important value that we get from being able to hold a company accountable in court is deterrence of bad practices. So one answer to what happens to, you know, the supposed flood of cases that would go into the civil courts is, there would be fewer cases; there would be fewer disputes because the companies would know that they could be held liable, and they would, therefore, act better to avoid liability.

Mr. COBLE. Well, thank you, gentlemen. My time has expired.

I yield back, Mr. Chairman.

Mr. COHEN. Thank you.

I recognize the gentleman from Georgia, Mr. Johnson, for 5 minutes.

Mr. JOHNSON. Thank you, Mr. Chairman.

I would like to hear some discussion about why a public proceeding, as opposed to a secret proceeding like you have in arbitration—why it is important for the freedoms that we hold dear under our Constitution.

Also, you know, this secrecy with respect to publishing a calendar so that the public—if it were not a secret proceeding, the public would be able to, you know, just for the heck of it, decide I am going to go just like I am going to go watch this civil trial in court. You cannot do the same thing in arbitration.

So I would like for you all to talk on that; also, the issue of mandatory rules procedurally; also the application of substantive law, the requirements or lack thereof in the secret arbitration process.

Lastly, there are some who believe, including myself, that there is really no meaningful right to appeal any decision that is made by these arbitrators. I will say that I am a big fan of all forms of alternative dispute resolution, including mediation, including arbitration and any other processes that are available, but I just firmly believe that those should—that those selections should be made after the dispute arises and not before the dispute arises.

So could I get some response, please?

Mr. DONOVAN. Congressman, maybe I am one of the few class action trial attorneys in the country, but I have had the honor of trying four class actions in the last 4 years, successfully each time, and I can tell you this. The need to have—there is a psychological benefit that is a civic benefit as well to people believing that they obtained justice in a public way; and it happens not just for the plaintiff who may succeed, but it is also for the defendant and for the members of the jury.

It is remarkable how empowered and important and good they feel about being part of the American fabric and of the American community by participating in what is, in essence, the most American thing you can participate in, and that is a jury trial. Even if you lose, I think everyone comes out of a jury trial feeling that, Well, look, I got a fair shake; I got a fair chance at justice. And this is, in essence, the American dream to present your case and to hear it and have it judged fairly with an American jury.

With respect to how that contrasts with what has happened in arbitration, I think the proof is in the pudding that arbitration is so—let me start with this, sir:

I, too, believe in mediation and in arbitration. In fact, in most of our cases, we resolve them by using mediators from the American Arbitration Association, from JAMS; and those are retired judges, and they mediate and resolve the cases, and we have used them. The difference is, we have decided to do so voluntarily, and each side approaches it with that idea, and they work out fine. We pay for it, and we think we have obtained justice.

However, when that decision has been made in advance, all of my clients who have experienced that arbitration process have felt wronged. They have felt disgusted and dirty by the process because that forced arbitration is not American. That forced arbitration is a perversion of justice, and the proof is in the pudding.

There are some instances in which courts have ordered cell phone companies and credit card companies to proceed in arbitration on a class-wide basis. In fact, I have had several cases where a court has said, Okay, you can go to arbitration, credit card company, defendant company, but you are going to go to arbitration on a class-wide basis—in other words, the arbitrator will decide class certification.

What has the defendant done in every one of those instances? No, no, no. We waive our right to arbitration. Why? Because they know that that would be unfair to them, at least in their perception.

So the whole goal of the proarbitration group is to do one thing, and that is to deny access to justice to American consumers. That is the only, sole goal for proarbitration in consumer credit card contracts, to deny access to justice; and I just think that is unpatriotic and wrong.

Mr. COHEN. Thank you for your questions, Mr. Johnson.

I now recognize the gentleman from California, Mr. Issa, for 5 minutes.

Mr. ISSA. Thank you, Mr. Chairman.

I will try to get the name right. Professor Drahozal.

Mr. DRAHOZAL. Very good.

Mr. ISSA. Last week—or actually, I guess it was last week at this point—we passed a reform bill out of the House overwhelmingly, that included changes as to whether contracts could, in fact, be changed at will.

Are you familiar with the legislation leaving the House?

Mr. DRAHOZAL. I know of the legislation. I cannot claim to be familiar with it.

Mr. ISSA. Well, would you say that it was consistent with limitations that we can place on government or, as government, on the private sector to say that a contract that is to be changed must be changed with notice and that that might have been a reasonable reform that would have responded to some of the other witnesses' statements that they made earlier, that this was an outrageous trend to sign binding arbitration and to have changes made without notice?

Mr. DRAHOZAL. Certainly—I mean, to the extent the concern is that consumers do not know what is happening, a notice requirement would be a direct response to that, absolutely.

Mr. ISSA. So, looking at binding arbitration changes versus changes in what we allow to be in the contract or in the fairness of contract in the first place, which would you prefer that we do, since it appears as though we have bills for both?

Mr. DRAHOZAL. Yes. I mean, given my role with the Searle task force, I am not really in a position to state a preference for what you all should do.

Clearly, there are alternatives to getting rid of consumer arbitration, through pre-dispute or otherwise. Altogether changing notice provisions would be one. I know Senator Sessions has, in the past, introduced a bill that would set out various procedural requirements to be followed in a consumer arbitration.

I mean, the other alternative, frankly, is that courts do actively police these, in particularly, class arbitration waivers. It is sort of striking. Increasingly courts are—when they are troubled by those sorts of clauses, stepping in and holding them unconscionable or otherwise unenforceable.

So there are other—I mean, we are not sort of comparing an anything-goes system to getting rid of predispute arbitration clauses. There are other, sort of intermediate steps.

I guess the final thing, just to mention briefly, is that at least some arbitration providers, like the American Arbitration Association, which is part of what we focus on in our study, have their own private fairness standards, which are similar anyway to the ones that were in Senator Sessions' bill, which they do effectively apply.

Mr. ISSA. Thank you.

Mr. Donovan, you know, you probably are a plaintiffs' trial lawyer.

Mr. DONOVAN. Yes.

Mr. ISSA. So I will not call you a hostile witness, but I will say you are predetermined to give certain answers and, perhaps, fair to give others.

If, in fact, we were to eliminate the preemption, the Federal preemption that we are dealing with and allow the States to each have authority over credit card disputes, would you generally favor that as a plaintiffs' trial lawyer?

Mr. DONOVAN. Well, you are talking to the lawyer who argued *Smiley v. Citibank* before the United States Supreme Court, and that was, of course, the case that said that, contrary to 190 years of history, late fees will now be deemed interest, because the OCC redefined "late fees" to be interest so as to preempt every State's law that limited late fees.

No. No. I think, with regard to credit card contracts, that it is appropriate to have a certain amount of uniformity under the Truth in Lending Act and certain centralized regulation.

What is wrong is for the Federal Arbitration Act to basically nationalize 50 States' laws and preempt those laws when it comes to contractual doctrines like unconscionability. Right now, the problem—and this is the reason why Congress needs to act. You have certain States that have said, California and the Second Circuit in

New York have said, Well, these certain provisions of credit card arbitration clauses are unconscionable, and they are unenforceable.

You have other States that say, Oh, we are sorry. We understand you have a very legitimate claim, ma'am, and you have a really good case, but—and we do not care how unconscionable the clause is, Federal law preempts.

Mr. ISSA. Let me do one follow-up for Professor Frankel.

A hypothetical: If we were to continue to allow States to reach different conclusions—and let us say that Visa or MasterCard or both chose not to do business in that State because it became punitive—even if competition came in and set up a one-State credit card system, would that be in the best interest of commerce to have essentially 49 States with one system, one with another, and no way for somebody to take their credit card and traverse the world?

Mr. FRANKEL. I mean, honestly, I do not see a realistic prospect of that happening. I think—that comes up in every situation, I think, where there is a request made to have Federal preemption in legislation that you cannot have this patchwork of different State laws. But I think the risk of that is more myth than reality, and there is not really much empirical evidence in that respect; and I think——

Mr. ISSA. Well, Mr. Chairman, if I could just broaden the question to anyone who wants to answer it. We have that in insurance, and insurance companies in many cases do not operate in California or in other States. So, if we assume for a moment that we mirror States' use in insurance and that occurs, is that in the best interest, from this side of the dais, to allow it to occur?

Anyone who wants to answer on that.

Mr. DONOVAN. The only difference is, in certain respects, Congressman, that does prevent systemic failures, as we saw with unregulated insurance companies like AIG and other activities that are not covered by State regulations. So, in that respect, you will prevent systemic failures.

In the credit card industry, I do not think it is realistic, because we do have a fair amount of uniformity in terms of national banking; and that was a system that was set up after the Civil War and in the midst of the Civil War.

I think what needs to be prevented——

Mr. ISSA. That was before I came to Congress.

Mr. DONOVAN. Yes. Me, too.

What needs to be prevented is this patchwork of arbitration decisions that you are now seeing, where some States are saying that you cannot have arbitration for credit card contracts and where other States are saying that you can, so that the person in Texas gets no justice and the person in California gets all the justice.

And that is what has really happened right now, so Congress needs to step in.

Mr. ISSA. Thank you.

Thank you, Mr. Chairman.

Mr. COHEN. Thank you, Mr. Issa.

I now recognize the Subcommittee Chairman on criminal law, the distinguished gentleman from Virginia, Mr. Scott.

Mr. SCOTT. Thank you, Mr. Chairman.

My friend from California's opening remarks mentioned centuries of jurisprudence, suggesting that credit card issuers may have an absolute right to these binding arbitration agreements.

Can somebody speak to the centuries of jurisprudence and how they apply to these claims, especially on adhesion contracts and antitrust, to demonstrate that we, consistent with centuries of jurisprudence, do have the authority to regulate these contracts?

Mr. DONOVAN. I hate to be hogging the floor, but it is my job, Congressman. Yes, I can speak to that.

You are alluding to the Second Circuit's decision in *Ross v. American Express* where that court has now allowed claims, that the credit card industry has conspired to all include arbitration clauses in their agreements, to go forward.

The fact of the matter is that there is a lot of evidence of that, because I saw the meetings. The lawyers for the credit card companies would get together at the American Bar Association meetings and come to agreements on what language they would include in credit card contracts, and they would all use that same language in their arbitration clauses. And they all got together and said: Oh, yes, yes, let us use this; this is good language.

Now, what they are trying to do is to provide, you know, a fine print opt-out. So, if the consumer receives this 25-page credit card agreement and does not opt out within 20 days of receiving it, that will be deemed consent to participate in arbitration. I mean, how silly is that?

I mean, that is ridiculous, but that is what—we are talking about people who are paid hundreds of thousands of dollars and who have earned major league MBAs to see how they can get $30 additional out of each one of their cardholders, because that brings $30 million to the bottom line this month.

That is what the reality of it is, and that is what they do. They go to school for it, and they get trained for it, and that is what is happening.

Now, in terms of 100 years or 200 years of jurisprudence, there has been 200 years of jurisprudence that has prohibited unfair, unconscionable, adhesive contracts. Those are contracts that are offered by the stronger party that take unfair advantage of the weaker party.

The definition of an "adhesive, unconscionable contract" is a credit card contract with an arbitration clause. And I am not the only one who says that; the California Supreme Court has said it, the Ninth Circuit Court of Appeals has said it. The only court that has not come out and directly said that is the United States Supreme Court, and the reason basically is that, until now, it basically has not had to confront that issue because, to the extent that it ever gets to that point, the credit card industry is wise enough to say, Okay, we give up, we settle; here is your $105 million. So that is basically it.

But the problem, Congressman, is that there are courts that will enforce these provisions. I mean, the Fifth Circuit enforces arbitration clauses, the Fourth Circuit enforces arbitration clauses; until recently, the Third Circuit Court of Appeals, my own court in Philadelphia, enforced arbitration clauses that required people with foreclosure disputes to go both before an arbitrator while their home was being foreclosed upon by a court. And this split-forum effect was that people had to have—you know, had to go to two different places at the same time to save their houses. They were enforcing those.

The reason why we need this Congress to act is because that is wrong. It is just not right. It should not happen, and the Arbitration Fairness Act should be passed.

I also want to say thank you to Congressman Johnson for pursuing this each year. I appreciate it.

Mr. SCOTT. So the point is, there is nothing inconsistent with centuries of jurisprudence? It is in no way inconsistent with centuries of jurisprudence?

Mr. DONOVAN. Not at all.

Mr. SCOTT. Mr. Arkush, can you tell me the status of the case that is pending, the Komarova case that you mentioned in your statement? Where is it procedurally?

Mr. ARKUSH. I believe, actually, that she has finally managed to get the award against her thrown out.

Mr. SCOTT. And is that a final decision, do you know?

Mr. ARKUSH. I believe so. Does anybody else know? I believe so.

Mr. DRAHOZAL. That would not surprise me because ground for vacating an award is if you never agreed to arbitrate in the first place. But I do not know the case.

Mr. SCOTT. Thank you.

Finally, Mr. Donovan, can you just make a quick statement? You have talked around this.

If a company comes up with a scheme where you rip off and defraud millions of people of a couple of dollars, what does prohibition against the class action do to those claims?

Mr. DONOVAN. Well, it basically prevents anybody from pursuing those claims.

But, you know, the real question here, Congressman, is there is a fine-line difference between, you know, a banker and a bank robber. A banker, if you take $1 from a million people, you are called a "banker," but if you take $1 million from one bank, you are called a "bank robber." Really, if, in fact, the 1 million people had as much clout as the banks have had, well, then those people would have outlawed this type of bank robbery.

Mr. COHEN. Thank you, Mr. Scott.

We are ready for our second round.

Mr. Franks.

Mr. FRANKS. Well, Mr. Chairman, I hardly know where to start. I have learned that a Federal trial is the most American thing we can do. You know, sometimes I think I want to step back here for a moment and ask myself, What are we really discussing here?

Really, what we are discussing is the agreement on the part of the credit card companies. They put in their agreements that—because there are oftentimes people who do not pay their bills, they put in the contract clause something that would require, as part of receiving the credit card, that people subject themselves to agreed binding arbitration.

My fear is that, if we do away with that, we will end up hurting a lot of people where they just do not get credit, because sometimes I think that my dear friends on the other side of the aisle feel that somehow, in Congress, we can repeal the laws of cause and effect in mathematics.

We saw that, I think, in the whole housing situation where well-motivated, well-intentioned efforts to help people have homes put great pressure on banks to make subprime loans and things like this that simply could not withstand the test of reality; and we ended up, I think, having largely a government-incented economic meltdown because of it.

If we continue to put more and more and more load on the economy and on the businesses and on the private sector here that are trying to make things happen that are ultimately good for everyone, I think we are going to wake up some morning and realize that we are kind of under all of it.

So I guess, Mr. Drahozal, I will just go ahead and ask you. The bottom line of your study, that consumer arbitrations you examined were faster than litigation, were cheaper than litigation and were essentially fair, was that pretty much the bottom line of your study?

Mr. DRAHOZAL. I cannot say quite that strongly at this point without the second phase of the study because, as you sort of—the comparison we have not yet done. Certainly, we found evidence that costs to the consumer, the up-front costs, actually are even lower than the low-cost arbitration rules provide for the AAA, and that the proceedings seemed to go at a fairly quick rate. There was certainly no evidence of any repeat player bias, as I discussed before.

So I guess I would agree with your statement with the caveat that we are not yet able to compare it to litigation, but that that phase will be coming.

Mr. FRANKS. Okay. Well, do you think it would be helpful to do additional research then in the process of doing that?

Mr. DRAHOZAL. Absolutely. Again, I have been very pleased with the focus that the Committee and commentators have had on empirical work, and it really seems to me important to know what you are getting into before you do it. And as you noted, the work is in progress, and we will be doing it as quickly as we reasonably and sort of conscientiously can do.

Mr. FRANKS. This is, rather, an obvious question, but when there are class actions on behalf of a group of consumers, isn't it true that most consumers receive a very, very, very small pittance amount for their part of the class action?

Mr. DRAHOZAL. There certainly are class actions like that. I mean, that seems to me to be actually another area where more detailed knowledge would be useful to know exactly how often, how much, and what consumers get and to what degree.

There was a recent study on employment arbitration, which obviously isn't directly applicable, but that compared what employees got in class actions to studies of what employees got in arbitration. And there are some issues with the study, but the study basically found that employees got more in arbitration than they did in class actions.

So that type of study would certainly be very useful to do in the consumer setting.

Mr. FRANKS. We have been told that there is a fine line here between bankers and bank robbers this morning. I am wondering, what group is favored the most with these class actions? Who makes the most money out of it?

Mr. DRAHOZAL. Well, with that one, I am not in a position to say. There are obviously various parties that make money, the lawyers probably on both sides. Presumably, the bankers do not make money through the class actions.

Mr. FRANKS. I would not think so.

Mr. DRAHOZAL. But, again, that is not something I can answer sort of definitively because it is beyond my area of expertise.

Mr. FRANKS. Well, it sounds like in class actions the consumers do not make a lot of money and the bankers do not make a lot of money, but it seems that it is pretty clear that the lawyers make a great deal of money.

I am being, you know, a little facetious here, but I felt like there had to be some response to some of the comments made here. So I guess the bottom line, Mr. Chairman, is that when we inject ourselves into the private market and say that you cannot make these kinds of agreements—because that is really what we are doing here.

There is nothing that forces arbitration on anyone that they do not agree to say, "Yes, I agree that I will subject myself to arbitration"; and to take that tool away from business is not only to clog our courts, but to make credit harder and more difficult to make available for the very people who need it most.

With that, I yield back.

Mr. COHEN. Thank you, sir.

Professor Drahozal, do you see a virtue in class action suits in general?

Mr. DRAHOZAL. Certainly, in theory, they are a very sensible way to resolve disputes if you aggregate small disputes.

Mr. COHEN. Does the class action attorney serve somewhat as a private attorney general in terms of showing up some defect in the business, the contract of the relationship, which could then be cured by the imposition of a large class action judgment?

Mr. DRAHOZAL. Again, that certainly is the theory behind class actions as well as attorneys' fees—shifting statutes and so forth. There are various ways that the justice system has structured things to try to give private parties incentives.

Mr. COHEN. So is there a way that you can see where you could have arbitration for smaller cases, individual cases, but still permit class action suits, so that when there is a uniform—not an individual but a uniform policy or activity that is taking place, such as the changing of the address on the barcode—that justice could be had through the civil courts?

Mr. DRAHOZAL. It seems to me there are two possibilities. One is a number of courts, as I noted earlier, have, in fact, refused to enforce class arbitration waivers, which has had the effect of the cases proceeding as class actions. I mean, that is, under the current structure of the Federal Arbitration Act, a permitted approach, and State courts have increasingly been doing that.

A second alternative would be arbitration on a class basis, which—I think, the AAA has several hundred cases now that it is administering on a class-wide basis. So there are ways in which arbitration can coexist with class relief.

Mr. COHEN. Professor Frankel, is there a way to have a bifurcated system where certain claims can go to class actions and jury trials and where others might be still limited to arbitration?

Mr. FRANKEL. I think that is certainly preferable to the system that we have now.

Just to build on what Professor Drahozal said in terms of courts that are refusing to enforce class action bans, I do not think that is an adequate substitute, because what is happening now is that credit card companies will write in, in their contracts, to apply that their contracts must be governed by the laws of States that will enforce class action bans. So they are getting around that by the way that they draft their contracts. So I do not think that is going to be an adequate substitute.

I think, you know, how you deal with their—there are still, I think, potential problems that some of the other witnesses have mentioned about individual cases, but I think removing sort of the class action types of cases in either saying, those can proceed in a class-wide arbitration or can proceed in class actions is certainly a benefit, but you have to make sure that there are the procedural protections that occur in class actions also.

Mr. COHEN. Thank you.

Mr. Donovan, you heard as I heard the statement that was repeated, I think, by quite a few Congress people, "plaintiff class action attorney," as if, you know, I guess, it is redundant. I guess you could be a defense class action attorney; I do not know.

In your case where the credit card company was changing the address, now, you were capable of going to court because that jurisdiction or that circuit does not recognize the ban; is that correct?

Mr. DONOVAN. Several of these cases preexisted the imposition of class prohibitions in arbitration or preexisted arbitration clauses in the credit card contracts. The credit card contracts basically started having arbitration clauses installed in them in about 2002. That is when the industry met at an ABA meeting and decided, "Let's put arbitration clauses in all of these contracts in order to destroy these claims that the industry was confronting."

So Providian predates that and the *Rossman v. Fleet* case where they said they promised no annual fee, but then they imposed an annual fee on everybody within 3 months. A lot of those cases predated arbitration. The subsequent cases are cases that emanate out of California where the California courts have found arbitration clauses that prohibit class actions to be unconscionable. So those proceed that way.

Mr. COHEN. In your particular case, what jurisdiction were you in?

Mr. DONOVAN. For the Fleet case, we were in Philadelphia. We were in the Federal court in Philadelphia and the Third Circuit Court of Appeals.

Mr. COHEN. So that was a preexisting situation?

Mr. DONOVAN. Correct.

Mr. COHEN. What was their defense? Did they say it was a mistake or did they just say, "We screwed people"?

Mr. DONOVAN. Well, in the Providian matter, the Providian matter was, you cannot bring any State law claims because they are all preempted by Federal law. In Federal law, the Truth in Lending Act allows us to do this, and, Oh, by the way, we are allowed to charge these late fees because they are permitted by the Truth in Lending Act. They basically had a preemption defense to that claim.

Mr. COHEN. I am talking about the one where they changed the address on the barcode.

Mr. DONOVAN. With changing the address on the barcode, we did not get to hear the defense because, once we pointed that out and the witness who testified about it, they settled.

Mr. COHEN. Never did they claim it was an accident?

Mr. DONOVAN. No, they never claimed it was an accident. In fact, there was a memo saying, Well, if we have everything sent to this, we will increase revenues by this amount.

Mr. COHEN. Under the system we have today, could you bring that action under a fraud charge and get around this, or would you be barred under the arbitration act?

Mr. DONOVAN. I do not think we would bring it as a fraud charge per se because fraud charges are hard to get certified as a class action. What you bring it as is a violation of the Truth in Lending Act. You bring it as a breach of contract. You bring it as an unfair, deceptive practice because there really was not a representation, a promise that said, Oh, by the way, this barcode says it is going to the right address, because nobody can read barcodes, so you cannot really have a fraud claim, but you could have an omission claim, and you could have that certified.

Could you bring that in an arbitration case? What it took was—it actually took a fair amount of forensic, you know, analysis. We had to spend the money to find out that is what was happening, because we could not figure out, Why are people sending these things 2 weeks in advance, but the bank is saying we did not get them? We finally figured it out, and then finally they came clean that, Oh, yes, we intentionally did that.

So—and then, you know—and then changing, you know, the Fleet case. What Fleet said was, Oh, yes, when we sent out the promotional rate that said "no annual fee," 3 weeks later the Federal Reserve increased interest rates, so therefore we have to put the annual fee on because otherwise our revenues will not be enough.

They sent out a letter saying, Because the Federal Reserve increased interest rates, we are going to impose an annual fee; and the court said, Uh-uh, "no annual fee" means at least no fee for the first year. Otherwise, it is a breach of contract.

Now, if there was an arbitration clause, you know, we were—Ballard Spahr was defense counsel. They were a very good firm, honorable, decent. They defended the case, and they came up with a lot of good arguments, preemption and everything. One individual person could not beat those lawyers; they are good lawyers. If they did not have other counsel, they would have lost. So you had to pursue that as a class case.

This happens—you know, look. The reality of it is that Citibank, Bank of America, Wells, they hire the best, brightest lawyers in the

Nation. Included among them is Sidley & Austin. I mean, you know, the Sidley & Austin firm defends the tax evasion, you know, the tax shelter cases, you know, where everybody said they got hit by the IRS because of tax shelters that were disallowed, and they bring claims against the accountants and the lawyers.

Well, the first thing that the defendants do in those cases is say, Oh, arbitration; oh, yes, we know we did not sign the arbitration clause, but a third party that we are related to, you know, by second-cousin status signed one, so we are subject to that arbitration clause.

And that is what the defendants do.

Mr. COHEN. Thank you, sir.

Mr. DONOVAN. So this has to be passed. The Arbitration Fairness Act has to be passed.

Mr. COHEN. Mr. Delahunt.

Mr. DELAHUNT. Yes. Thank you, Mr. Chairman.

If there is a provision in a credit card contract that says at the end of the terms and conditions that the credit card company or issuer can change the terms at any time they want, and all the terms and conditions that were enumerated previously, would that fit the definition of an "adhesion contract"?

Mr. DONOVAN. Well, that is what the credit card contracts are now. Yes, they are adhesion contracts because they are take-it-or-leave-it contracts. You either take it or you leave it. That is what the adhesive thing is.

The thing that is different about the credit card contract—and they try to justify this because it is a revolving line of credit—is that they can change any term at any time for any reason. So if you are counting on having this money at 6 percent interest for a year, because that is when the date of your expiration on your card is——

Mr. DELAHUNT. Mr. Donovan—and my point is and I obviously agree with you and I understand that, but to call that a "contract" is, you know, flattery taken to a different level. I mean, that is just—that is a joke. That is what it really is. Of course, it is an adhesion contract.

When I hear that, Well, you have contractual obligations, that is not a contract. It just is not a contract.

In terms of class actions, one aspect of the rationale for class action suits is to serve as a deterrent to bad practices. In other words, it is not just simply above compensating or redressing those members of the class, but it is preventing bad behavior post the ruling, the decision in the case.

Am I stating it accurately, Mr. Donovan?

Mr. DONOVAN. The way I like to look at it, Your Honor, is—because we always talk about this from the perspective of consumers or homeowners or anything. It is a moral hazard. This device imposes a moral hazard on credit card companies to "do not do this, or else you are going to increase the cost on you alone." So it imposes a moral hazard on the whole thing so others who are observing it will not do that, too.

The benefit is that that helps investors to have confidence to buy these securities that are backing up the credit card product; and the moral hazard is then presented on the bad actor alone, pinpointed, and the others get to observe, and they are deterred from engaging in the same bad practice.

Mr. DELAHUNT. Thank you. That is all I have.

Mr. COHEN. Mr. Johnson, do you have any further questions?

Mr. JOHNSON. Not at this time, Mr. Chairman. I would be happy to yield the balance of my time to either one of my colleagues here, Mr. Delahunt or to, of course, Mr. Scott.

Mr. COHEN. Thank you, sir.

Mr. Scott, you are recognized with the balance of Mr. Johnson's time.

Mr. SCOTT. Thank you, Mr. Chairman.

I do not have any questions, but I would just thank the panel, particularly Mr. Donovan, for pointing out that adhesion contracts do not have to be enforced, and that is absolutely consistent with centuries of jurisprudence.

Furthermore, if you conspire with others to put the same provisions in a contract, that violates that antitrust law so that what we are doing with these bills—what we are doing is absolutely consistent with centuries of jurisprudence. What the bills would do would be to add some consistency, so regardless of what State you are in, you can benefit from reasonable consumer law.

I would yield back.

Mr. COHEN. Thank you, Mr. Scott.

I do not know if we need another round or not but, Mr. Franks, do you have any further questions?

If not, I think we have had a very healthy discussion, and I think there has been the best attendance that we have had at this Subcommittee. I want to thank the witnesses on the issue for eliciting that. We thought we had to call the fire marshal at one point—too many Members up here—but we did not, so I would like to thank you all for your testimony and for your attemtiveness.

Without objection, Members have 5 legislative days to submit any additional written questions, which we will forward to the witnesses and will ask you to answer as promptly as you may, and it will be made part of the record.

Without objection, the record will remain open for 5 legislative days for the submission of any other additional materials.

I thank everyone for their time and patience. This hearing of the Subcommittee on Commercial and Administrative Law is hereby adjourned.

[Whereupon, at 12:04 p.m., the Subcommittee was adjourned.]

APPENDIX

Material Submitted for the Hearing Record

Response to Post-Hearing Questions from Michael D. Donovan, Esq.,
National Association of Consumer Advocates

Response of Michael D. Donovan to Questions for the Record
Subcommittee on Commercial and Administrative Law
Hearing on the Federal Arbitration Act: Is the Credit Card Industry Using It To Quash Legal Claims?
May 5, 2009

Response of Michael D. Donovan to Questions from Honorable Steve Cohen, Chairman

1. **In response to a question from Chairman Cohen, you referred to Congress passing legislation to prohibit arbitration in credit contracts involving members of the Armed Services. Please explain further in detail.**

1. In passing the The John Warner National Defense Authorization Act for Fiscal Year 2007, H.R. 5122, Congress included a provision expressly prohibiting enforcement of arbitration clauses in any agreement involving the extension of consumer credit to any covered member [of the Armed Services] or dependent of such a member. *See* 10 U.S.C. § 987(f)(4), codifying Pub.L. 109-364, Div. A, Title VI, § 670(a), Oct. 17, 2006, 120 Stat. 2266.

2. **Clearly arbitration offers some benefits. If we are to retain arbitration, how would you change arbitration to make it fair to all parties to a dispute?**

2. Arbitration offers many benefits to parties who have relatively equal bargaining power, resources and sophistication. It also provides substantial benefits to parties who knowingly and voluntarily choose to arbitrate a dispute after the dispute has arisen. Arbitration that is mandated or forced upon another party by a party with far greater power, resources and sophistication cannot be fair, and cannot be constructed to be fair. I do not believe it is possible to change arbitration of disputes between consumers and credit card issuers so that it is fair to all parties. Consumers, in this regard, are really no different from members of the Armed Services, so mandatory arbitration should be prohibited in all such disputes involving the extension of consumer credit.

3. **One of the many arguments for arbitration is that it is less costly than litigating in the traditional court system. Do you agree? Is it less costly for cardholders? For credit card issuers?**

3. No, I do not agree that arbitration is less costly than litigating in the traditional court system either for cardholders or for credit card issuers. In fact, arbitration adds another procedural hurdle and exponentially increases costs for all parties when a proper apples to apples cost comparison is made. For example, for ordinary debt collection matters, arbitrator decisions can only be enforced through a petition to the courts to confirm the arbitral award. This petition replicates in many respects the debt collection complaint a credit card issuer would have simply filed in court if arbitration did not exist. Given recent arbitral forum abuses, several states (including Pennsylvania) have implemented civil procedure rules that prohibit enforcement of arbitration awards unless the initiating party has first commenced a judicial proceeding and established proper service of process. *See, e.g.*, Pa. R. Civ. P. Rules 1326-1329. In response to a petition to confirm, a consumer against whom an arbitration award was entered may raise many

of the same arguments and even more – such as improper service of process; no proof of an agreement; etc. – that would have been raised absent the arbitration. As a result, arbitration nearly always increases the costs of collection for a card issuer.

For consumers with common claims against a particular card issuer, the costs also are increased geometrically. Ordinarily, these claims would be handled in a class action. With arbitration, however, each consumer would have to pursue the claim individually. With class litigation, the claims of 100,000 consumers might be litigated to conclusion for a litigation cost of $1 million, which works out to $100 per consumer for attorney fees, filing fees, expert costs and all related expenses. This does not include the recovery each class member would receive, and the costs are rarely if ever paid by the class members if the class litigation is unsuccessful. The actual costs for 100,000 individual arbitrations or traditional court cases would far outstrip these costs. Without doubt, each consumer would incur a minimum of $1,000 in costs to pursue his or her claim, meaning that individual arbitration would cost at least 10 times more than class litigation. The only cost savings would come not from an apples to apples comparison, but from a distorted apples to oranges comparison. Because so many people would recognize that the individual costs and distraction would far outstrip the likely individual recovery, far fewer people would pursue their individual claims (perhaps as few as .5%). This means that consumers would forgo any recovery, and the offensive conduct would go unchallenged. Assuming the likely consumer recovery approximated $100 per consumer, the lost costs from the unchallenged conduct would be $995,500, not including the loss of deterrence, which again shows that arbitration is far more costly than traditional litigation. To be sure, the credit card issuer would then be able to keep this illegal profit, and therefore contend that arbitration is less costly, but that contention would be and is specious. In truth, the only cost savings resulting from arbitration in the consumer credit context comes not from the less formal characteristics of arbitration but from the fact that it deters and prevents claimants from pursuing their legitimate claims. In other words, arbitration only saves money for credit card issuers because it enables them to keep money they stole from credit cardholders.

4. **In your written statement for the hearing, you indicate that credit card companies are arguing that the Federal Arbitration Act prohibits federal courts from examining whether the credit card companies and the arbitrators complied with due process of cardholders in attempting to obtain default judgments. What due process have cardholders alleged the credit card companies and arbitrators ignored?**

4. In *Hall Street Associates, LLC v. Mattel, Inc.*, ___ U.S. ___, 128 S. Ct. 1396 (2008), the Supreme Court held that an arbitration award "must be confirmed" unless the award was procured by fraud, corruption or undue means; there was evident partiality or corruption of the arbitrators; the arbitrators were guilty of refusing to postpone the hearing or refusing to hear pertinent or material evidence; or the arbitrators exceeded their powers. *Id.* at 1402 & n.3 (citing 9 U.S.C. §§ 9-11). These grounds do not, on their face, include alleged violations of due process, leading credit card companies to argue that such alleged violations may not be raised in response to a petition to confirm an arbitration award. As indicated in the *Komarova amicus* brief attached to my written testimony, consumers have alleged due process violations where arbitration providers have entered default awards against individuals who were documented

victims of identity theft, individuals who were never properly served with notice of the arbitration, and individuals who never agreed to arbitrate their dispute. *See Komarova* Amicus Brief pp. 16-17 (citing cases). Other due process violations include the conduct of "hearings" in distant fora thousands of miles from the consumer's residence, failure to require the production of pertinent evidence, insisting on the deposit of vast sums for arbitrator fees before a live hearing will be conducted, entering summary awards without requiring answers to discovery or information requests, and failing to permit cross examination and confrontation of credit card company witnesses. These due process violations are particularly troublesome in debt-buyer actions, where purported paper records of an alleged debt are submitted, but the debt-buyer has no record or witness able to attest to the accuracy, calculation or history of the alleged account.

5. In your written statement for the hearing, you allege that credit card companies have couspired to iuclude arbitration agreemeuts in their cardholder agreemeuts. Please explain in more detail and how this impacts cardholders.

5. The Court of Appeals for the Second Circuit addressed this very point in the decision in *Ross v. American Express Co.*, 547 F.3d 137 (2d Cir. 2008). The cardholders of nearly all of the major credit card issuers allege in that case that the card issuers agreed at various bar association and banker meetings to include mandatory binding arbitration clauses in each of their cardholder agreements. In fact, practically every cardholder agreement available now includes a binding arbitration clause and class action waiver. This makes it impossible for a consumer to contract with any card issuer without a mandatory arbitration clause and class action waiver, because there are none. As the Court of Appeals in *Ross* acknowledged, this reduces the value of the credit cards to all consumers and increases the costs of credit, because it makes it economically impossible for one monitor or group of monitors of credit card practices to benefit all other cardholders, which drives up consumer monitoring costs and increases the risk of error, thereby reducing the value of the credit card to all consumers. This lack of monitoring on a portfolio basis also drives up the costs and risks of securitization, which again increases the costs of credit to all consumers. Please refer to the *Ross* decision for further details.

6. Are mandatory binding arbitration agreements really mandatory? If a cardholder is unhappy with an arbitration agreement, cannot the cardholder simply refuse the agreement and take their business to a different credit card issuer?

6. In theory, a consumer who opposes arbitration might simply refuse to do business with a seller who includes such a clause in his contract. With credit cards, however, there are virtually no cards available that do not include both a mandatory binding arbitration clause and a class action waiver provision. More significantly, these provisions are not highlighted in advance and are buried in the fine print of multi-page cardholder agreements that are delivered only after the account has been opened. There are no issuers to my knowledge who advertise the fact that their credit card does not require arbitration, so there is no market differentiation on this basis and no real market choice for consumers to avoid arbitration. Moreover, because credit cards are issued on a take-it-or-leave-it basis, there is no opportunity to negotiate individual terms for the agreement, or to reject some terms but not others. Hence, credit card arbitration provisions are in fact mandatory.

7. Banks are the primary issuers of credit cards. And as you stated in your written testimony, most if not all of these issuers include arbitration agreements in their terms of use agreements. Do credit unions include arbitration agreements in their terms of use agreements too?

7. I am aware that some credit unions also include mandatory binding arbitration provisions in their account holder agreements. I do not know whether most or all do, as I have not studied many credit union agreements.

8. During the hearing, you were responding to a question from Rep. Issa concerning allowing the states to have authority over credit card disputes. It seems you were unable to finish responding. Please do so here.

8. The Federal Arbitration Act preempts states from singling out arbitration clauses from other contract terms, thereby preventing the states from ensuring that consumer arbitration is conducted on a fair basis or based on informed consent, adequate notice or convenient locations. Representative Issa indicated that if the states were permitted to adopt provisions affecting consumer credit or consumer arbitrations, some credit issuers, like some insurers, might choose not to do business in a particular state or states. This argument, while theoretically possible, is wholly unrealistic when it comes to the consumer credit market. In fact, permitting states to regulate consumer credit and consumer arbitration in accordance with the interests of their consumers would return a proper balance to the consumer credit markets. Currently, the most populous states, California, New York, Texas, New Jersey, Illinois and Pennsylvania have virtually no control over consumer credit agreements entered into by citizens of their states. The least populated states, Delaware, South Dakota, Nevada and Utah, by contrast, have become domestic credit card havens so that banks can export from these locations terms that are the least favorable to and least protective of consumers who reside in the most populated states. This is because federal law has not adopted a truly federal and representative standard, but instead has borrowed a state standard based on the geographical "location" of the card issuing bank. To attract such banks, the lesser populated states have adopted lax standards that would not be adopted or implemented in more populated states.

In other words, current banking law operates as if domestic Cayman Island banking provisions were being exported to more populated regions without the consent of their residents as if it was the law of the United States, even though no member of Congress has ever voted on the issue. While some may argue that California in effect dictates commercial law for the rest of the country due to the size of its market, with respect to consumer credit that is not case. If the states could individually regulate consumer credit while operating within the same electronic payment system, it would be highly unlikely that the availability of credit in any one state or any group of states would be impacted in any material way. In fact, such a result would certainly reduce the risk of systemic failure, as it would bring about a diversity of credit issuers and increase competition in the industry. Besides, the individual states already exert some power to nullify arbitration terms in consumer credit agreements under the doctrine of "unconscionability." In California, for example, the courts have held that using arbitration terms to bar small value consumer claims is "unconscionable" because it denies access to the courts for legitimate claimants. Other states have not followed this reasoning yet, but the fact remains that no credit card issuers have left the California market as a result of the judicial decisions in that state. Therefore, Congress should outlaw mandatory binding arbitration in all consumer credit agreements and either adopt federal banking standards or eliminate the domestic Cayman Island design of the federal banking laws.

RESPONSE TO POST-HEARING QUESTIONS FROM RICHARD H. FRANKEL, ESQ., DREXEL UNIVERSITY EARLE MACK SCHOOL OF LAW

Questions for the Record
Subcommittee on Commercial and Administrative Law
Hearing on the Federal Arbitration Act: Is the Credit Card Industry Using It To Quash Legal Claims?
May 5, 2009

<u>Richard H. Frankel, Esq., Drexel University Earle Mack School of Law</u>

Questions from the Honorable Steve Cohen, Chairman

1. **As a law professor familiar with the Federal Arbitration Act, and all of the arguments for and against mandatory arbitration, what would you propose to ensure that the spirit of arbitration is maintained, while protecting consumers?**

The spirit of arbitration, as envisioned by the members of Congress who enacted the Federal Arbitration Act in 1925, was that arbitration clauses would be the product of arms-length negotiations between two sophisticated businesses that were aware of types of disputes likely to arise in the future and that had the power to bargain over specific contractual terms. In other words, arbitration was intended to be a process that parties voluntarily entered into with the full awareness of its risks and benefits That spirit, however, is not reflected in the current practice of imposing standard-form arbitration provisions that are presented to unsophisticated consumers on a take-it-or-leave it basis.

I think the best way to maintain that original spirit is to return arbitration to being a voluntary process. The best way to achieve that goal is to limit the reach of binding arbitration provisions to post-dispute contexts rather than pre-dispute contexts. If, after a dispute has arisen, both parties decide that arbitration is the preferred forum, then the dispute should go to arbitration. But that is a far cry from the current practice of requiring consumers to send all disputes, no matter the shape or size, to arbitration, even before the consumer has any idea of what types of disputes might arise.

2. **During the hearing, you were responding to a question from Rep. Issa concerning Federal preemption of state laws affecting credit card use. It seems yon were unable to finish responding. Please do so here.**

I understand Congressman Issa's concern over the risk that in a regime governed by state law, credit cards might be deterred from operating in specific states. However, I do not think it is a problem, for several reasons. First, regardless of the preemptive reach of the Federal Arbitration Act, credit card companies still receive substantive preemptive protection through other federal laws. For example, federal banking statutes make credit card companies exempt from state interest-rate caps. Cabining the preemptive reach of the FAA will not alter those substantive protections. Second, I think there is an even greater risk of the opposite result, that is, that credit card companies will flock to the state with the most lax regulations, creating a "race to the bottom." That credit card companies will engage in a "race to the bottom" regarding arbitration is borne out by companies' use of choice-of-law provisions to protect class-action bans and other one-sided provisions that the companies place in their arbitration agreements. Although not all states will enforce such choice-of-law provisions, many do, and they demonstrate the risk of allowing an interest in uniformity to undercut valuable consumer protections.

Additionally, FAA preemption has expanded so far that the FAA does not just preempt "punitive" state laws to which Congressman Issa refers, but it preempts almost any judicial or legislative rule that constrains arbitration in any way. The far-reaching doctrine of FAA preemption prevents states from enacting reasonable regulations on the arbitration process intended to curb arbitration's worst abuses. The problem here is not the hypothetical risk that some state might in the future decide to enact a law that has a punitive effect on the credit card industry, but the current reality that states are forbidden from undertaking virtually any regulation of arbitration whatsoever.

3. **Consumer advocates argue that arbitration clauses can be drafted to undermine certain legal protections, such as consumer lending laws protecting credit cardholders. Are companies, particularly the credit card industry, drafting clauses to do that?**

Yes. The most fundamental way that credit card companies draft their arbitration clauses to undermine consumer protections laws is by banning consumers from proceeding on a classwide basis, either in court or in arbitration. Many illegal practices by credit-card companies cause exactly the sort of small-dollar, high-volume claims that cannot be brought on an individual basis and that class actions are especially designed to handle. The ban on class actions gives credit card companies virtual immunity from such practices, because they know that no one will pursue such claims on an individual basis. Although some companies are adding opt-out provisions for consumers, they do so solely to insulate themselves from legal challenges on unconscionability grounds, while knowing full well that consumers are unlikely to read the opt-out provision or to understand the nature of the opt-out right provided.

Another way that companies draft arbitration clauses to limit consumers' ability to vindicate their legal rights is by limiting discovery. In many consumer disputes, the relevant evidence is in the hands of the corporate party, and unless the consumer can obtain that evidence, the consumer will not succeed. Many consumer cases are complex and involve multiple defendants, yet an arbitration clause may limit a party to a few interrogatories and a single deposition. Such limitations on discovery create an uneven playing field and make it difficult for plaintiffs to prove meritorious cases.

Finally, some companies undermine consumer protection laws by writing into their contracts that arbitration will be conducted through the National Arbitration Forum (NAF). I have less knowledge than some of the other witnesses about this issue, but there is mounting evidence that the NAF harbors an anti-consumer, pro-corporation bias, and it is my understanding that the NAF specifically markets itself to corporations as a way for corporations to limit their legal liability.

4. At what point did the use of arbitration by the credit card industry become more prevalent? Did other industries begin to use arbitration at the same time too?

I am not an expert on this question, but it is my understanding that the use of arbitration clauses by the credit card industry became widespread around the end of 1999. In early 1999, only two or so major credit card providers used arbitration clauses. By the end of 1999, virtually all major credit card companies started including them in their standard-form contracts. See, e.g., In re Currency Conversion Fee Antitrust Litigation, 2005 WL 2364969 at *9 (S.D.N.Y. Sept. 27, 2005) (describing the spread of arbitration clauses across the credit card industry). As for other industries, I believe that automobile dealers began using arbitration clauses on a widespread basis around 2002-2003. In the nursing home context, the spread of arbitration clauses has occurred more recently. Right now, it is my understanding that an overwhelming majority of nursing homes use arbitration clauses, but that was not the case even as recently as five or six years ago.

5. How did mandatory binding arbitration between equal commercial entities expand into the consumer-business realm where the parties are generally not equal, such as between credit card companies and their cardholders?

I believe that two factors contributed to the spread of arbitration from the commercial realm to the consumer realm. First, it is my understanding that a small number of companies experimented with arbitration clauses as a way of reducing liability exposure and eliminating class action lawsuits. When those companies found some degree of success at curtailing consumers from vindicating their rights, other companies followed suit. In the 1990s, a small group of defense lawyers began advising their clients to impose arbitration provisions in their consumer contracts as a way of limiting their liability exposure.

Second, the U.S. Supreme Court facilitated the expansion of forced arbitration provisions into the consumer sector through a series of far-reaching and controversial decisions. First, in Southland Corp. v. Keating, 465 U.S. 1 (1984), the Court held that the FAA established federal substantive law of arbitration that applies not just in federal court, also in cases arising in state court raising solely state law claims. Second, in Gilmer v. Interstate/Johnson Lane Corp., 500 U.S. 20 (1991), the Court gave the green light to arbitration of statutory and other public law claims in addition to contractual claims. More recently, in Allied-Bruce Terminix Cos. v. Dobson, 513 U.S. 265 (1995), the Court extended arbitration to consumer claims by interpreting the FAA to extend to the limit of Congress's power under the Constitution's Commerce Clause, rather than just to traditional commercial transactions. These decisions expanded the reach of the FAA beyond what Congress originally intended, and enabled corporations to require arbitration of virtually any type of dispute, regardless of the relative bargaining power of the parties, the subject matter of the dispute, or whether the dispute raised questions of public rights rather than purely private rights.

6. In reference to a statement by Rep. Issa, Rep. Scott stated the following during the hearing: "My friend from California's openiug remarks mentioned centuries of jurisprudence, suggesting that credit card issuers may have an absolute right to these binding arbitration agreements." Please respond to Rep. Issa's suggestion.

As I understood Congressman Issa's comment, the Congressman was suggesting that regulating arbitration could be inconsistent with 200 years of contract law. I do not believe this is the case. Rather, it is the current doctrine of FAA preemption -- which exempts arbitration provisions from state regulation -- that is inconsistent with longstanding contract doctrine by giving arbitration clauses a privileged status that is unlike any other contract.

The history of contract law does not support the notion that parties have an absolute right to freedom of contract free of all constraints whatsoever. The notion of such an absolute right was repudiated by the Supreme Court in the first half of the Twentieth Century when it rejected corporate arguments that it was unlawful to regulate practices like child labor and the minimum wage because such regulations interfered with a company's freedom of contract. Few believe that we should return to the era where contracts operated as a shield against corporate responsibility. Instead, contract doctrine has long been subject to regulation and modification through the common-law power of the courts, and through the authority of the state legislature. As contracts become ever more common in society and are used between parties with wide disparities in knowledge and bargaining power, the ability of states to protect the health, safety and welfare of their citizens through regulation of contracts has become increasingly important.

Arbitration clauses, however, unlike other contracts, are not subject to state regulation because any regulations that constrain arbitration are preempted by the FAA. In fact, courts have explicitly ruled that certain generally applicable contract doctrines do not apply to arbitration clauses because they are overridden by the FAA. The best way to maintain consistency with this country's contract law traditions, in my view, is to limit the FAA's preemptive reach rather than to declare that the FAA creates an absolute right to contract that supersedes state law.

RESPONSE TO POST-HEARING QUESTIONS FROM CHRISTOPHER R. DRAHOZAL, ESQ., UNIVERSITY OF KANSAS SCHOOL OF LAW

Questions for the Record
Subcommittee on Commercial and Administrative Law
Hearing on the Federal Arbitration Act: Is the Credit Card Industry Using It To Quash Legal Claims?
May 5, 2009

Christopher R. Drahozal, Esq., University of Kansas School of Law

Questions from the Honorable Steve Cohen, Chairman

1. **Consumer advocates argue that some businesses forbid class actiou lawsuits with the use of arbitration clauses. What effect does this have on consumers arbitrating their claims?**

Most consumer arbitration clauses in the cases we studied did not preclude class relief.[1] In arbitrations arising out of those contracts, arbitration on a class basis almost certainly would be available for consumers arbitrating their claims if the standards for proceeding on a class basis otherwise are met.[2]

For those consumer arbitration clauses with class arbitration waivers, an increasing number of courts, both state and federal, hold the waivers to be unconscionable and thus unenforceable.[3] In such cases, the consumers would either be able to proceed in arbitration on a class basis (if the court severs the invalid class arbitration waiver), or else in court in a putative class action (if the court does not sever the invalid class arbitration waiver). A substantial percentage of arbitration clauses in credit card contracts (among others) include "non-severability" provisions, which provide that if the class arbitration waiver is invalidated the arbitration clause should be invalidated as well.[4] As a result, in states in which courts hold class arbitration waivers unenforceable, credit card holders likely will be able to bring class actions in court.

When courts find class arbitration waivers enforceable, usually after examining whether the consumer can vindicate his or her rights in arbitration, the consumer must proceed on an individual basis in arbitration. In the next phase of the Searle study, we are examining class

[1] Searle Civil Justice Institute, *Consumer Arbitration Before the American Arbitration Association: Preliminary Report* 103 (March 2009), *available at* www.searlearbitration.org (finding that almost two-thirds (63.5%) of the clauses studied did not include class arbitration waivers). None of the insurance contracts or real estate brokerage agreements included class arbitration waivers, and only about half of the car sale contracts (34 of 64, or 53.1%). However, all of the credit card contracts in the sample (26 of 26) included class arbitration waivers.

[2] *See* American Arbitration Association, Supplementary Rules for Class Arbitrations (effective Oct. 8, 2003), *available at* http://www.adr.org/sp.asp?id=21936.

[3] *See, e.g., In re* American Express Merchants' Litigation, 554 F.3d 300, 319-20 (2d Cir. 2009); Alan S. Kaplinsky et al., *Consumer Arbitration: The Tug of War Between the Federal and State Courts Intensifies*, 64 BUS. LAW. 627, 627-28 (2009).

[4] Theodore Eisenberg et al., *Arbitration's Summer Soldiers: An Empirical Study of Arbitration Clauses in Consumer and Nonconsumer Contracts*, 41 U. MICH. J.L. REF. 871, 885 (2008).

actions as a possible type of court proceeding to compare to individual arbitrations, but we do not yet have any results to report.[5]

2. **Your written statement for the hearing focused on the recent Searle Civil Justice Institute report on consumer arbitration. That report analyzed a select group of consumer arbitration results decided by arbitrators for the American Arbitration Association. How representative is the Searle report if the survey only analyzed one arbitration provider? Did the Institute contact the other arbitration providers to participate? If so, what was there response?**

As the question indicates, and as we note in our Preliminary Report, our results are limited to consumer arbitrations administered by the American Arbitration Association (AAA) and so are not necessarily representative of all consumer arbitrations.[6] That limitation applies as well to the results of studies of arbitrations administered by other arbitration providers, such as the National Arbitration Forum,[7] which also are not necessarily representative of all consumer arbitrations.

The AAA is the oldest and best known provider of arbitration services in the United States. Studies of AAA employment arbitration have concluded that it "offers an affordable, fair, alternative adjudicative forum" for employees.[8] But much less research has been done on the AAA's consumer caseload. We set out in the Searle study to begin filling that gap, on the view that such information is necessary for making an informed decision on what national policy on arbitration should be.

We have not contacted other arbitration providers as part of the study. Due to time and resource constraints, as well the large amount of information to review on AAA consumer cases, we have chosen to focus our study on those cases.

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[5] One complication in doing the comparison is the apparent difficulty in finding out the extent to which class actions actually benefit the individual class members. See Nicholas M. Pace & William B. Rubenstein, *How Transparent are Class Action Outcomes?: Empirical Research on the Availability of Class Action Claims Data* (July 2008) (RAND Working Paper Series WR- 599-ICJ), *available at* http://www.rand.org/pubs/working_papers/WR599/. In the employment setting, a recent study found that the mean and median potential individual recoveries in the class actions studied were consistently less than the mean and median recoveries in individual employment arbitrations reported in other studies. Samuel Estreicher & Kristina Yost, *Measuring the Value of Class and Collective Action Employment Settlements: A Preliminary Assessment*, *in* EMPLOYMENT CLASS AND COLLECTIVE ACTIONS: PROCEEDINGS OF THE N.Y.U. 56TH ANNUAL CONFERENCE ON LABOR 107, 136 (David Sherwyn ed. 2009).

[6] Searle Civil Justice Institute, *supra* note 1, at 111.

[7] *E.g.*, Public Citizen, *The Arbitration Trap: How Credit Card Companies Ensnare Consumers* (Sept. 2007).

[8] Elizabeth Hill, *AAA Employment Arbitration: A Fair Forum at Low Cost*, DISP. RESOL. J., May/July 2003, at 9; *see also* Elizabeth Hill, *Due Process at Low Cost: An Empirical Study of Employment Arbitration Under the Auspices of the American Arbitration Association*, 18 OHIO ST. J. ON DISP. RESOL. 777 (2003).

3. The Searle Civil Justice Institute report shows that in over 80 percent of the cases in which a business claimant won, they received between 90 and 100 percent of the amount in controversy. But only in about 31 percent of the cases in which a consumer won, did the consumer receive between 90 and 100 percent of the amount they claimed. Even if the types of cases brought are different for businesses and consumers, those numbers still seem to favor businesses in arbitration. Please explain the disparity in numbers.

As I discuss in more detail below (in response to question no. 5), the differing results obtained by business claimants and consumer claimants in arbitration do not in themselves show that arbitration is biased in favor of businesses. As the question notes, the types of claims brought by businesses often differ from the types of claims brought by consumers. Businesses tend to bring claims for amounts they are owed for services already rendered. Thus, the most common business claimants in the sample were home builders, real estate brokers, and other service providers, such as accounting firms and law firms.[9] In such cases, the business faces fewer hurdles to establishing liability, and, when it does so, the amount it should be awarded is relatively easy to calculate and prove. Hence, in many cases the business is able to recover a high percentage of the amount it seeks. Consumers tend to bring claims alleging delivery of defective goods or improper performance of services. Thus, the most common business respondents in the sample were car dealers and insurance/warranty companies.[10] Such cases present more difficult questions of proving both liability and damages. Accordingly, consumers tend to win less often in cases that make it to an award, and, when they do win, tend to recover a lower percentage of the damages they seek.

We are continuing to examine this issue, and plan to address it further in an upcoming report, as discussed below.

4. Do you have any numbers on how many consumer-business disputes, particularly credit card disputes, the American Arbitration Association arbitrates? What percentage of the total number of disputes the American Arbitration Association arbitrates are credit card disputes?

Of the 301 AAA cases we examined in detail, 26 (or 8.6% of the sample), involved credit card companies.[11] A roughly equal percentage of cases with business claimants and cases with consumer claimants arose out of credit card agreements.[12] A slightly higher, albeit unquantified, percentage of the broader dataset of AAA cases (which included cases that settled or otherwise were dismissed before an award) were credit card cases.[13]

9 Searle Civil Justice Institute, *supra* note 1, at 50.
10 *Id.*
11 *Id.* at 103.
12 *Id.* at 51 fig. 3.
13 *Id.* at 51.

As I indicated in my written statement, the Searle study did not break out the various results from the study based on the type of contract giving rise to the dispute.

5. The Searle Civil Justice Institute study found that consumers won some relief in 53.3% of the cases they filed in arbitration, while businesses won some relief in 83.6% of the cases they filed. Would you please define what "some" relief is? Please explain how the use of arbitration is fair if businesses are winning a higher percentage of their cases, and also a higher amount of the money they are claiming, as compared to consumers?

In calculating the "win-rate" of consumers and businesses in arbitration, the Searle study used the standard definition of a "win" – a claimant "wins" if he or she recovers some amount of money or some other relief in arbitration. That definition has its limitations; it treats a claimant as winning as long as the claimant recovers something, regardless of how much the original claim was worth. If the claimant (either a business or a consumer) recovers only a small fraction of what a claim is worth, the claimant nonetheless will be treated as winning by this definition. When the Searle study refers to consumers and businesses winning "some relief," it is recognizing upfront this possible limitation of the win-rate as a measure of success.

An alternative measure of how well consumers and businesses fare in arbitration is what percentage of the amount the claimant seeks that it is able to recover. This measure also has limitations. It assumes that the amounts claimants seek accurately reflect the value of the underlying claim, which may well not be the case. Some types of claims are easier to value than others. For example, a business claimant seeking to recover the amount of an unpaid bill can more readily and accurately value the amount of its claim than a consumer seeking to recover the loss in value of a defective product.

Whether outcomes in arbitration are fair depends on how those outcomes compare to the outcomes of similar cases in court. In fact, although we are examining the issue further, it appears that business claimants in court also win more often than consumer claimants do. For example, a study of contract cases in federal court under diversity jurisdiction, although likely involving higher stakes than the cases in our sample, reported almost identical win-rates as those in AAA consumer arbitrations. According to Marc Galanter:

> We see that not only do corporate plaintiffs win more often, they win even more frequently as both plaintiffs and defendants when opposing individuals than when opposing other corporations. They won 90% of the cases in which they sued individuals and lost only 50% of the cases in which individuals sued them.[14]

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[14] Marc Galanter, *Contract in Court; Or Almost Everything You May or May Not Want to Know About Contract Litigation*, 2001 WIS. L. REV. 577, 600 & tbl. 4 (citing Theodore Eisenberg & Henry S. Farber, *The Litigious Plaintiff Hypothesis: Case Selection and Resolution*, 28 RAND J. ECON. S92, S99 (1997) (studying federal diversity cases for the years 1986-94, excluding personal injury cases)).

Again, these win-rates – from contract cases in federal court – are almost identical to those found in the Searle study. They suggest that whatever the reason for the differing success rates of business and consumer claimants, they are not due to bias in arbitration or deficiencies in the arbitration process.

Instead, as we indicated in our Preliminary Report, the differing success rates for business claimants and consumer claimants appear to result from two factors.[15] First, the types of claims businesses in our sample bring differ from the types of claims consumers bring, as discussed above in connection with question no. 3. Second, a significant number of business claims are resolved on an ex parte basis, because the consumer failed to respond to the demand for arbitration.[16] (This phenomenon appears to be common in court as well; when businesses sue consumers in court to collect a debt, the consumer defendants often fail to appear and are subject to default judgments.) Conversely, the business respondent appeared in every case brought by a consumer. We are unable to determine whether the consumer fails to respond because they are likely to lose in the arbitration, or they are more likely to lose in arbitration because they fail to respond. But regardless, the substantially greater number of defaults is an important factor in explaining the higher success rate of business claimants.

We are continuing to examine this issue, and plan to address it further in an upcoming report. But nothing we have seen so far suggests that the differing success rates of business claimants and consumer claimants are a result of bias in arbitration.

6. A fair arbitration process would include neutral arbitrators. Who are generally the arbitrators hearing disputes? Are they equally representative of plaintiff's and defendant's attorneys? Are there some arbitrators that seem to rule favorably for consumers or businesses all of the time?

I agree absolutely that a neutral decision maker is an essential characteristic of a fair arbitration proceeding. Accordingly, courts have refused to enforce arbitration clauses that provide for biased arbitrators,[17] and the Federal Arbitration Act (as well as state arbitration statutes) provides for courts to vacate awards when the arbitrator acts with "evident partiality."[18]

In addition, the Consumer Due Process Protocol, which the AAA applies to the consumer arbitrations it administers, provides that "[a]ll parties are entitled to a Neutral who is independent and impartial" and that the parties "should have an equal voice in the selection

[15] Searle Civil Justice Institute, *supra* note 1, at 70.

[16] *Id.* at 70 n.59 ("Twenty-two out of the sixty-one cases (or 36.1%) brought by business claimants were resolved on an ex parte basis.").

[17] *E.g.*, Walker v. Ryan's Family Steak Houses, Inc., 400 F.3d 370, 385-87 (6th Cir.) ("The Arbitration Agreements and related rules and procedures at issue in this case demonstrate that EDSI's arbitral forum is not neutral and, therefore, the agreements are unenforceable."), *cert. denied*, 546 U.S. 1030 (2005).

[18] 9 U.S.C. § 10(a)(2); Unif. Arb. Act, § 12(a)(2).

of Neutrals in connection with a specific dispute."[19] The Searle study examined the AAA's enforcement of the Protocol, including the provisions dealing with arbitrator neutrality. It found only four clauses in the sample that were problematic under these provisions of the Protocol,[20] and in every case the AAA properly identified the provision and responded to it by requiring the business to waive its application.[21]

As part of the next phase of the Searle study, we will be studying arbitrator selection in AAA consumer arbitrations. When that phase of the study is completed, we hope to have answers to exactly the sorts of questions being asked. We do know, as reported in the Preliminary Report, that only a small percentage (less than 10%) of the cases in the Searle study involved repeat combinations of arbitrators and businesses or arbitrators and business attorneys.[22] In other words, it is not common for the same business to appear before the same arbitrator in the cases in our sample. Otherwise, however, we do not yet have answers to the questions asked.

7. **In response to a question from Ranking Member Franks, you stated that "Looking at the empirical results, there is a dispute about how you treat settlements. . .I mean settlements benefit the consumer, so they should be seen as sort of a, quote/unquote, 'win' for the consumer." Please explain in greater detail the empirical results. Also, please explain why settlements benefit the consumer. Do they always benefit the consumer? Likewise, do they always benefit the business/creditor/company?**

The discussion the question refers to concerned the high business win-rates reported by Public Citizen and others in consumer arbitrations administered by the National Arbitration Forum.[23] Other studies have found much lower business win-rates, when either settlements[24] or dismissals before a hearing[25] are included as wins for the consumer. As far as settlements are concerned, presumably both parties believed that settling the dispute was preferable to the alternative of continuing to arbitrate the case, and to that extent both sides certainly benefit. But not having studied the NAF process in detail, I am not able to take a position on whether settlements or dismissals should be treated as wins for consumers in that context.

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19 National Consumer Disputes Advisory Committee, Consumer Due Process Protocol, principles 3 & 4 (Apr. 17, 1998), *available at* http://www.adr.org/sp.asp?id=22019.

20 Searle Civil Justice Institute, *supra* note 1, at 86: "None of the clauses gave the business control over arbitrator selection or the pool of prospective arbitrators. Instead, all of the clauses were problematic because they required the arbitrator to have qualifications that might give rise to questions about the arbitrator's impartiality. Three of the clauses were in car sales contracts and required, at least under some circumstances, that the arbitrator be a certified master mechanic. The other clause was in a home inspection contract and required that the arbitrator be an experienced member of one or another association of home inspectors."

21 *Id.* at 89-90.

22 *Id.* at 80-81. And many of those cases involved a related set of disputes arising out of a single event. *Id.* at 81 n.86.

23 *Public Citizen*, *supra* note 8.

24 Ernst & Young, Outcomes of Arbitration: An Empirical Study of Consumer Lending Cases 16, App. A (2004), *available at* http://www.adrforum.com/rcontrol/documents/ResearchStudiesAndStatistics/2005ErnstAndYoung.pdf.

25 Jeff Nielsen et al., Navigant Consulting, National Arbitration Forum: California Consumer Arbitration Data 1 (July 11, 2008), *available at* http://www.instituteforlegalreform.com/component/ilr_issues/29/item/ADR.html.

RESPONSE TO POST-HEARING QUESTIONS FROM DAVID ARKUSH, ESQ., PUBLIC CITIZEN

Questions for the Record
Subcommittee on Commercial and Administrative Law
Hearing on the Federal Arbitration Act: Is the Credit Card Industry Using It To Quash Legal Claims?
May 5, 2009

David Arkush, Public Citizen

Questions from the Honorable Steve Cohen, Chairman

1. **Take the following example: a credit card company overcharges its cardholders by $25 and does not refund the $25 upon request of the cardholders. What options do the cardholders have? It does not seem likely that each cardholder will file a complaint in court for that $25. Would class action litigation be the best approach? What effect would an arbitration agreement have if one was included in the terms of use agreement?**

A consumer with a claim for $25 against a credit card company is unlikely to find recourse without participating in a class action. The only practical way to challenge high-probability, low-magnitude harms, like overcharging fees on credit cards and other consumer products, is through class actions. *See Scott v. Cingular Wireless*, 161 P.3d 1000, 1005 (Wash. 2007). The mere costs of gasoline or vacation time from work to appear in court or participate in arbitration (not to mention the arbitration filing fees) are enough to deter consumers from pursuing their small claims individually. If the $25 claim results from a policy or practice that affects thousands or millions of customers, then a class action is the best option, not just for the consumers whose otherwise worthless small claims become viable to pursue, but for the broader public, which benefits from the deterrent effect on future misconduct.

Arbitration clauses in credit card contracts often contain class action bans. Because proceeding on a class basis is the only viable option for many consumer claims, these bans effectively immunize credit card providers from accountability for a broad range of unfair, deceptive, or otherwise predatory practices. *See* Oren Bar-Gill & Elizabeth Warren, *Making Credit Safer*, 157 U. PA. L. REV. 1, 78 (2008) ("The widespread inclusion of arbitration clauses in standard credit card contracts inoculates lenders against the possibility of class action lawsuits, which would otherwise change the economics of pursuing debtor's rights.") As Judge Richard Posner has written, "[t]he *realistic* alternative to a class action is not 17 million individual suits, but zero individual suits, as only a lunatic or a fanatic sues for $30." *Carnegie v. Household Int'l, Inc.*, 376 F.3d 656, 661 (7th Cir. 2004).

2. **Consumer advocates argue that some businesses forbid class action lawsuits with the use of arbitration clauses. What effect does this have on consumers arbitrating their claims?**

Preventing class proceedings in arbitration has the same effect that it has in court: It renders consumers unable to pursue many important claims and, conversely, renders corporations immune from accountability for a host of bad practices.

In industries like consumer credit, in which these types of harms are more common, arbitration clauses sometimes provide the appearance of generosity, for example stating that the corporation will pay all or part of the arbitration fees. But the same clauses also prohibit consumer class actions, making that apparent generosity a charade. When claims fall below a certain value, consumers have no economic incentive to pursue them, even if someone else will pay some of the costs. The claims are feasible only if brought on a class basis.

3. **Does mandatory binding arbitration benefit cardholders? Are the suggested costs saved through mandatory arbitration passed on to the cardholders?**

Some businesses argue that forced arbitration lowers the cost of goods for consumers and that they will be forced to raise costs if Congress curbs the practice. As I noted in my testimony, businesses made a similar argument in favor of the Class Action Fairness Act. It has been five years since CAFA passed, and we still await a morsel of evidence demonstrating that it lowered costs for consumers.

Forced arbitration raises costs for consumers because it enables businesses to engage in unfair business practices with relative impunity. This is evidenced by the galloping rate at which credit card providers have increased their revenue through unfair fees, penalties, and interest rate hikes—practices that proliferated at the same time as forced arbitration spread throughout the industry.

In fact, class action litigation can actually lower the cost of goods for consumers by halting practices that harm consumers. In 2003 we analyzed six consumer class actions that have demonstrably reduced costs for consumers. *See* Public Citizen, *Six Common Transactions That Cost Less Because of Class Actions* (Aug. 30, 2003). One example we discussed was *Rossman v. Fleet Bank* 280 F.3d 384 (3d Cir. 2002), a case litigated by another witness, Michael Donovan. In *Rossman*, consumers sued a credit card issuer for first advertising a "no annual fee" card and then seeking to impose a $35 annual fee less than six months after the consumer opened an account. The fee notice also stipulated that the interest rate would increase from 7.99 percent to 24.99 percent if cardholders cancelled their cards while carrying a balance. The United States Court of Appeals for the Third Circuit held that these acts violated the Truth in Lending Act.

4. **According to proponents of mandatory arbitration, the courts rigorously protect consumers from unfair arbitration agreements. Are they correct? Can we not just depend on the courts to protect consumers from unfair arbitration clauses?**

The courts do not protect consumers adequately from unfair arbitration agreements. To the contrary, the courts are responsible for much of the problem with forced arbitration. I discuss that point more below in response to question 6.

The affirmative argument that courts protect consumers from unfair arbitration agreements ignores three important characteristics of consumer arbitration jurisprudence.

First, the United States Supreme Court has given the Federal Arbitration Act extremely broad preemptive scope, which severely limits the ability of state courts to protect their citizens from unfair forced arbitration agreements. State courts may invalidate arbitration clauses only "upon such grounds as exist at law or in equity for the revocation of any contract." 9 U.S.C. § 2. The Supreme Court has interpreted this to mean that state courts cannot directly asses the fairness of arbitration agreements at all; instead, they must rely solely on general contract principles like fraud, duress, or unconscionability. They also may not invalidate arbitration agreements under state laws applicable only to arbitration provisions. *See Doctor's Associates, Inc. v. Casarotto*, 517 U.S. 681, 687 (1996).

As a result, arbitration clauses are invalidated only under theories such as unconscionability, which are highly difficult to satisfy. Thus it is hard to invalidate even the most oppressive forced arbitration clause, much less a clause that is merely grossly unfair.

Second, courts invalidate forced arbitration clauses only on a case-by-case basis at best, which imposes a terrible burden on consumers and their attorneys. Even the most egregious clause might remain in use in 49 states after one state court rules it unconscionable. Moreover, even in that state, the companies might simply make minor changes to the wording of the clause and continue using it, forcing consumers to relitigate the clause's validity repeatedly.

Third, the unfairness of many arbitration clauses scarcely touches on the inherent unfairness of forced arbitration itself. Regardless of whether a particular forced arbitration *clause* is fair, the dispute resolution process it establishes is not fair. There is an inherent conflict of interest in forced arbitration: Arbitration firms have a strong incentive to favor the companies that choose them, not to provide consumers a fair forum.

Moreover, the courts are nearly powerless to reverse unfair or unsound arbitration decisions. The exclusive grounds for reversal provided by the FAA are limited to demonstrable bias on the part of the arbitrator and a handful of other narrow grounds. *See* 9 U.S.C. § 9. Law professor and forced arbitration advocate Peter B. Rutledge has called judicial review of the merits of arbitration decisions "virtually non-existent." Peter B. Rutledge, *Market Solutions to Market Problems: Re-examining Arbitral Immunity as a Solution to Unfairness in Securities Arbitration*, 26 PACE L. REV. 113, 131-32 (2005). The United States Court of Appeals for the Seventh Circuit has interpreted the FAA to mean that a judge cannot overturn an arbitrator's decision even if the arbitrator's interpretation of a contract is "wacky." *Wise v. Wachovia Securities, Inc.*, 450 F.3d 265, 269 (7th Cir. 2006).

5. **A witness who testified at one of this Subcommittee hearings last term had written an article suggesting that mandatory binding arbitration agreements are a defense against consumer litigation. How neutral is mandatory arbitration agreements if they are considered a defense to consumer lawsuits?**

Forced arbitration has nothing to do with neutrality. It provides corporations a one-way "justice" system in which they can pursue claims against consumers more easily—even claims with no evidentiary support and dubious legality—and in which consumers are deterred from bringing most claims at all. Forced arbitration advocate Alan Kaplinsky has said that "[a]rbitration is a powerful deterrent to class-action lawsuits against lenders[.]" Paul Wenske, *Some Cardholders Are Signing Away Their Right to Sue*, KAN. CITY STAR, Apr. 3, 2000. In addition to class action bans, forced arbitration can impose steep fees at multiple steps in the process—including loser-pays rules that saddle consumers with paying the very corporate lawyers who defeated their claims in the biased forum.

The disincentives of arbitration appear to be quite effective, as evidenced by the exceedingly low rate of consumer-initiated arbitrations. Public Citizen's 2007 *Arbitration Trap* report found that consumers brought only 118 claims out of 33,948 credit card arbitrations before the National Arbitration Forum (NAF) between 2003 and 2007.

There is nothing neutral about a forum that enables large corporations to prevail even on dubious claims against consumers while preventing consumers from bringing meritorious claims against corporations.

6. **In reference to a statement by Rep. Issa, Rep. Scott stated the following during the hearing: "My friend from California's opening remarks mentioned centuries of jurisprudence, suggesting that credit card issuers may have an absolute right to these binding arbitration agreements." Please respond to Rep. Issa's suggestion.**

The notion that a multibillion dollar corporation can force a party with grossly less bargaining power—an individual consumer—into a private, secretive forum of the corporation's choosing has no basis in centuries-old common law. In fact, the practice directly undermines the common law, as there is no rule of law in private arbitration. It also undermines one of three pillars of United States government: open, public courts.

It is unlikely that anyone would have envisioned the current practice of forced arbitration when the Congress enacted the Federal Arbitration Act in 1925. The FAA was intended to provide an informal dispute resolution mechanism for businesses to resolve disagreements. *See, e.g.*, Jean Sternlight, *Creeping Mandatory Arbitration: Is It Just*, 57 STAN. L. REV. 1631, 1636 (2005). At the time, arbitration was voluntary, chosen by sophisticated parties that had real bargaining power with respect to each other. *Id.* at 1635-36. Beginning in 1983, however, the United States Supreme Court opened the door for large corporations to force their customers and non-union employees into arbitration. *See* David S. Schwartz, *If You Love Arbitration, Set It Free: How "Mandatory" Undermines "Arbitration,"* 8 NEV. L. J. 400 (2007). Prior to 1985, statutory causes of action reflecting "important public policies" were exempt from mandatory arbitration. *Id.* at 406. A series of Supreme Court decisions from 1985 to 1991 erased this distinction. *Id.* at 407.

Forced arbitration did not become widely used in the credit industry until the late 1990s. In 2005, credit cardholders filed an antitrust action alleging that the 13 largest card issuers illegally colluded to require mandatory arbitration clauses in their cardholder agreements. *Ross v. Bank of America, N.A*, 524 F.3d 217, 220 (2d Cir. 2008). The plaintiff cardholders accuse the banks of forming an "Arbitration Coalition" in late 1998 or early 1999 to "'force[] unwilling and unaware cardholders to accept arbitration clauses and class action prohibitions on a 'take-it-or-leave-it basis' through the joint exercise of immense market power.'" *Id.* at 220-21. Regardless of whether the allegations in this suit are true, the fact remains that credit card arbitration is an exceedingly recent practice. The FAA dates only to 1925; the Supreme Court decisions that enabled widespread forced arbitration date only to the past thirty years; and the proliferation of forced arbitration clauses in consumer contracts occurred only in the past decade.

7. **I imagine that you are familiar with the Searle Civil Justice Institute study. Can you explain why there is such a large disparity in some of the results between the Public Justice [sic] 2007 report and the Searle report?**

Our 2007 *Arbitration Trap* report found that consumers lose an astounding 94 percent of credit card arbitrations before NAF between 2003 and 2007. The Searle Center study by Professor Drahozal studied consumer arbitrations before the American Arbitration Association (AAA) and found that businesses received an award in 84 percent of cases they brought and won 93 percent of what they asked for in those cases. These figures are not dramatically lower than the 94 percent win rate we reported in the *Arbitration Trap*.

Notably, the data set for Drahozal's study concludes just before AAA began operating a massive credit card operation mill. Drahozal's study considered just 301 AAA arbitrations decided between April and December 2007. Since December 2007, AAA has processed more than 45,000 cases filed by Midland Credit Management, a Kansas-based collection agency. We have studied this data set. In the cases in which an award was issued, AAA gave Midland more than 94 percent of the amounts it sought. In 87 percent of cases, AAA awarded Midland the precise amount it sought—to the penny.

Yet even the Searle study provides evidence that AAA arbitration is unfair to consumers. Drahozal reports that consumers received awards in 53 percent of the cases they brought and, in those instances, received about 52 percent of the amount they sought. In sum, this means consumers received just 28 percent of what they sought. By contrast, businesses received roughly 78 percent of what they sought.