*Discover Bank v. Superior Court of Los Angeles**

I. INTRODUCTION

Consumer advocates and trial lawyers scored a major victory when the California Supreme Court recently found that consumer credit card companies cannot require customers to waive their right to class action arbitration in a contract of adhesion.[1] While the Court ultimately remanded the case to decide a critical choice of law issue, they did so only after resolving two key issues. First, the Court held that a waiver of class action arbitration in a consumer contract of adhesion is unconscionable under certain circumstances.[2] Second, the Court concluded that the Federal Arbitration Act (FAA) does not preempt the prohibition of class action waivers in arbitration agreements.[3]

Although the practical effects of the decision have yet to be seen, the Court has sent a strong message that the enforceability of class wide arbitration waivers will be closely examined. At the very least, in the future, corporations such as credit card companies will have to change their tactics and provide customers with more rights if they want to prohibit class wide arbitration.

II. FACTS AND PROCEDURAL HISTORY

Plaintiff Christopher Boehr obtained a credit card from Defendant Discover Card in April 1986.[4] The credit card agreement contained a choice of law clause providing for the application of Delaware and federal law, but it did not contain an arbitration clause. The arbitration clause was added in July 1999 in the form of a notice sent with the credit card bill. The notice stated that any claims or disputes from the date of the notice forward would be settled by arbitration and that the FAA would govern.[5] The notice went on

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* Discover Bank v. Superior Court, 36 Cal. 4th 148 (2005).

[1] *Id.*

[2] *Id.* at 153.

[3] *Id.*

[4] *Id.*

[5] Specifically, the notice stated as follows:

> Notice of Amendment . . . We are adding a new arbitration section which provides that in the event you or we elect to resolve any claim or dispute between us by arbitration, neither you nor we shall have the right to litigate that claim in court or to have a jury trial on that claim. This arbitration section will not apply to lawsuits filed before the effective date.

to preclude either side from "class wide arbitration, consolidating claims, or arbitrating claims as a representative . . . ."[6] The agreement was deemed to be accepted unless the card holder objected and ceased using his or her account. The plaintiff continued using his account and was thus deemed to have accepted the agreement.

The plaintiff filed a class action complaint in August 2001 in which he alleged breach of contract and violation of the Delaware Consumer Fraud Act (DCFA).[7] He claimed that Discover Bank breached its cardholder agreement by imposing a late fee on payments that were received on the due date but after an "undisclosed '1:00 p.m. cut-off time.'"[8] He further claimed that Discover Bank "imposed a periodic finance charge . . . on new purchases when payments were received on the payment due date, but after 1:00 p.m."[9]

Discover Bank moved to dismiss the class action based on the class action waiver in the arbitration agreement. The plaintiff opposed the motion, asserting that the class action waiver was unconscionable under California law. The trial court initially granted Discover Bank's motion, but the Plaintiff moved for reconsideration after the Fourth District Court of Appeal decided *Szetela v. Discover Bank*.[10] In *Szetela* the court found that a class action waiver that was "virtually identical" to the waiver being considered in the present case was unconscionable.[11] In light of *Szetela*, the trial court agreed with the plaintiff and found the waiver to be unconscionable and unenforceable.[12] Discover Bank subsequently filed a writ petition seeking reinstatement of the lower court's original order enforcing the arbitration clause.[13] The appellate court granted the writ and upheld the Discover Bank class action waiver.[14] In coming to this conclusion the appellate court did not

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Id.

[6] *Id.* Specifically, the notice stated as follows: "Neither you nor we shall be entitled to join or consolidate claims in arbitration by or against other cardmembers with respect to other accounts, or arbitrate any claim as a representative or member of a class or in a private attorney general capacity." *Id.* at 153–54.

[7] *Id.* at 154 ("The act in part prohibits misrepresentations of any material fact with intent that others rely upon such concealment, suppression or omission in connection with the sale, lease or advertisement of any merchandise." (citing DEL. CODE ANN., tit. 6, §§ 2511–27 (2005))).

[8] *Id.*

[9] *Id.*

[10] *See* Szetela v. Discover Bank, 118 Cal. Rptr. 2d 862 (Cal. Ct. App. 2002).

[11] *See Id.* at 864.

[12] *Discover Bank*, 36 Cal. 4th at 155.

[13] *Id.*

[14] *Id.*

take issue with the fact that class action waivers are unconscionable or unenforceable. Rather, it simply held that the FAA governed the agreement and preempted any California rule prohibiting class action waivers.[15] The California Supreme Court subsequently granted review of the case.

III. THE COURT'S HOLDING AND REASONING

The Supreme Court of California found that "at least under some circumstances, the law in California is that class action waivers in consumer contracts of adhesion are unenforceable . . . ."[16] The Court also reversed the appellate court's finding that the FAA preempts California law with respect to class action waivers and remanded the choice of law issue.[17]

A. *The Unconscionability of Class Action Waivers*

A primary consideration for the Court in declaring the class arbitration waiver unconscionable in this case was the historic public policy rationale in favor of class wide arbitration. This rationale originated in *Keating v. Superior Court*—the case which originally led the Court to devise the procedure of class wide arbitration.[18] There the Court stated:

> Denial of a class action in cases where it is appropriate may have the effect of allowing an unscrupulous wrongdoer "to retain the benefits of its wrongful conduct. . . . [c]ontroversies involving widely used contracts of adhesion present ideal cases for class adjudication; the contracts are uniform, the same principles of interpretation apply to each contract, and all members of the class will share a common interest in the interpretation of an agreement to which each is a party."[19]

Thus, there is no question that public policy considerations favor the use of class wide arbitration when it is necessary and that class wide arbitration provides consumers with important protections.

In addition to strong public policy considerations, the Court considered several factors in finding the particular class action waiver in *Discover Bank* unconscionable. First, the Court found that there is an element of procedural

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[15] *Id.* The Court found that *Szetela* failed to analyze the preemption issue.

[16] *Id.* at 153.

[17] *Id.*

[18] Keating v. Superior Court, 31 Cal. 3d 584 (1982) (citations omitted).

[19] *Id.* at 609 (citations omitted).

unconscionability "when a consumer is given an amendment to its cardholder agreement in the form of a 'bill stuffer' that he would be deemed to accept if he did not close his account."[20] Second, the Court found that because damages to individual consumers are often small, the only way to prevent a company from reaping an unjust profit by exacting small amounts from every customer is with the class action mechanism.[21] To waive such a mechanism would be unjust. Finally, the Court agreed with *Szetela* that although Discover Bank also waived its right to use class wide arbitration, "it is difficult to envision the circumstances under which the provision might negatively impact Discover, because credit card companies typically do not sue their customers in class action lawsuits."[22] Discover Bank was essentially using a one sided, exculpatory contract of adhesion to shield itself from liability. Under California law, the court found the waiver to be unconscionable and unenforceable.[23]

B. *The FAA and Preemption*

The Supreme Court of California disagreed with the appellate court's finding that the FAA preempted California law in this case. At the outset the Court noted that both California law and federal law under the FAA favor enforcement of valid arbitration agreements unless grounds exist for the revocation of any contract.[24] The Court then examined Section Two of the FAA which provides that "a state court may refuse to enforce an arbitration agreement based on generally applicable contract defenses, such as fraud, duress, or unconscionability."[25] Reasoning that unconscionability is a general principle of California contract law that is not federalized by the FAA, the Court found that the FAA does not preempt state law.[26]

The Court noted that the appellate court was wrong to ignore the "critical distinction . . . between a 'state-law principle that takes its meaning precisely from the fact that a contract to arbitrate is at issue,' which is preempted by [Section Two] of the FAA, and a state law that 'governs issues concerning

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[20] *Discover Bank*, 36 Cal. 4th at 160.

[21] *Id.* at 161.

[22] *Id.* (quoting *Szetela*, 118 Cal. Rptr. 2d at 867).

[23] *Id.* at 161.

[24] *Id.* at 163. The Court further clarified: "In other words, although under federal and California law, arbitration agreements are enforced 'in accordance with their terms' such enforcement is limited by certain general contract principles . . . ." *Id.* (citations omitted).

[25] *Id.* at 165 (citations omitted).

[26] *Id.* at 167.

the validity, revocability, and enforceability of contracts generally,' which is not [preempted]."[27]

C. *Choice of Law*

In resolving the unconscionability and preemption issues, the Court still did not provide a complete resolution to the case. A complex choice of law provision remains. Although there is a Delaware choice of law provision in the Discover Card agreement, the Plaintiff is attempting to enforce Delaware laws in a California court with a California unconscionability rule against class action waivers that is not explicitly found under Delaware law.[28] The Court remanded this issue for the appellate court to decide. The appellate court will now have to determine whether Delaware law applies and, if it does, whether Delaware law permits the enforcement of a class arbitration waiver under the circumstances of this case.[29]

IV. THE IMPACT OF *DISCOVER BANK*

The effects of *Discover Bank* may be very broad. The ruling will prevent California companies from using class arbitration waivers to escape potentially devastating lawsuits. Before the decision in *Discover Bank*, plaintiffs could not aggregate small individual claims to prevent a company from making a large, cumulative, unjust profit, but now companies will have to own up to their unfair practices or face class arbitration lawsuits.[30] As F. Paul Bland, a staff attorney with Trial Lawyers for Public Justice and a member of plaintiff Christopher Boehr's counsel, stated, the decision will have an "enormous effect in California and will make it impossible for companies to use class arbitration bars as a get out of jail free card."[31] Bland

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[27] *Id.* at 165 (quoting Perry v. Thomas, 482 U.S. 483, 493 n.9 (1987)).

[28] *Id.* at 173–74.

[29] *Id.*

[30] The "unfair practices" include the actions of Discover Bank in this case. Discover Bank was accused of imposing late fees on payments that were received on the payment due date, but after Discover Bank's undisclosed 1:00 p.m. cut-off time. *See supra* note 8 and accompanying text. While damage to each individual cardholder was not extreme—the plaintiff's late fee was a mere $29—damage to all card holders resulted in a significant profit to Discover Bank. The class arbitration waiver was a useful device for Discover Bank to escape broad liability while also discouraging plaintiffs from filing suit.

[31] ADRWorld.com, *California Supreme Court Restricts Class Arbitration Waivers* (June 29, 2005), http://www.adrworld.com/sp.asp?id=38589.

went on to suggest that the case could also have a "very significant impact on other courts" presented with class arbitration waiver issues.[32]

There is evidence that the case is already having an effect on California courts. In *Parrish v. Cingular Wireless*,[33] in a factual situation very similar to that of *Discover Bank*,[34] the Fourth District Court of Appeal of California originally held that a "contractual ban on class-wide arbitration is *not* unduly one-sided, harsh, or in violation of public policy."[35] Since *Discover Bank* was handed down, however, the *Parrish* decision has been vacated.[36] While the long range effects of *Discover Bank* remain to be seen, the case will certainly create more consistency and judicial certainty on the issue of class wide arbitration bans.

A more specific impact of the ruling is that it undermines the powerful FAA preemption defense used by companies to escape state law. By closely examining the preemption issue the Court signaled that preemption is no longer necessarily a magic word when it comes to interpreting and enforcing arbitration clauses. As Professor Jean Sternlight of the William S. Boyd School of Law at the University of Nevada, Las Vegas noted, "companies use the preemption argument often in court, but the unanimous decision 'rejects the aggressive interpretation of preemption' under the FAA."[37] Companies are now on notice that the FAA does not automatically preempt state law and in California arbitration agreements will be closely scrutinized on the issue.

The ruling will also lend more importance to choice of law clauses. Companies may begin to specify forums with weaker consumer protection laws that will validate class arbitration waivers. Finally, some see the ruling as an important step in reducing the amount of arbitration in California by allowing individuals to aggregate their claims into one arbitration proceeding.[38]

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[32] *Id.*

[33] Parrish v. Cingular Wireless, 28 Cal. Rptr. 3d 802 (Cal. Ct. App. 2005).

[34] The fact situation in *Parrish* involved a wireless telephone service agreement which allowed only individual claims—rather than class wide arbitration claims—to be heard. *See Id.* at 805.

[35] *Id.* (emphasis added).

[36] *See* Parrish v. Cingular Wireless, 118 P.3d 1017 (Cal. 2005).

[37] ADRWorld.com, *supra* note 31.

[38] *Id.*