Written Testimony

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Hearing on: the Federal Arbitration Act: Is the Credit Card Industry Using it to Quash Legal Claims?

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## 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

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[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 web-sites, 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

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[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

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|---|---|
| | 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. <u>The Economist</u>, 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

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[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-

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[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.*

*With Susann Rutledge*



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IN THE COURT OF APPEAL OF THE STATE OF CALIFORNIA

FIRST APPELLATE DISTRICT

DIVISION 1

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

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

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**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 protection 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

[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

[4] "Single-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 Anastasiya—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.

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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

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[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

Samuel Issacharoff [FNd1]

Erin F. Delaney [FNdd1]



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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