

Challenging Arbitration Agreements for Unconscionability: An Uphill Battle for Employees and Others

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In stating that contracts to settle “by arbitration” controversies involving commerce “shall be valid, irrevocable, and enforceable,” the Federal Arbitration Act (FAA) clearly expresses a preference for arbitration over litigation. The FAA leaves the door ajar for the possibility that arbitration agreements are subject to nullification if “grounds ... exist at law or in equity for the revocation of any contract.”¹ Consistent with this provision, courts have recognized a number of grounds for invalidating arbitration agreements, one of which is unconscionability arising from excessive economic power of one party.

Recent cases illustrating the difficulty of persuading a court to invalidate an arbitration agreement on the ground that it is procedurally and substantively unconscionable under state law.

The settled law is that “private agreements to arbitrate are enforced according to their terms” without regard to the subject matter of the dispute and subject only to the threshold issue as to whether the clause is unconscionable.² The FAA’s endorsement of arbitration was incorporated into the original Uniform Arbitration Act, and continued in the revised UAA (RUAA) approved in 2000 by the National Conference of Commissioners on Uniform State Laws (NCCUSL), which has been adopted in some 14 jurisdictions and is pending in a few others.³ What is true at the federal level is generally (although not universally) true at the state level. As a result, parties who desire to be released from the obligation to arbitrate face an uphill battle when they seek to have a court declare an arbitration agreement invalid and unenforceable. What

Stanford Jr. University, the Supreme Court observed that the parties may limit by contract the issues that they will arbitrate, or opt for a broad arbitration clause that encompasses all disputes. They also may agree to arbitrate “gateway” arbitrability questions.⁷ In *Rent-A-Center v. Jackson*, one of the Court’s most recent decisions, the Court emphasized that arbitration is a matter of consent, not coercion, “so parties are generally free to structure their arbitration agreements as they see fit.”⁸

In many challenges to the enforceability of an arbitration agreement, the complaining party alleges that the repugnant contract is one of adhesion, a contract prepared by the party with greater bargaining power that is essentially non-negotiable. However, adhesion contracts generally are enforceable. The business community argues that without

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is termed unconscionable by the complaining party may be no more than a subjective sense of oppressiveness. Too frequently, parties seeking relief from arbitration agreements offer argument rather than evidence. They fail to understand that no amount of legal argument can persuade a court without factual evidence.

The uphill nature of the complaining party’s battle is evidenced in three recent decisions discussed in this article: one by New York’s highest court, another by the 2nd Circuit, and the third by a district court in the same circuit. Collectively, they illustrate the strength of the policy in favor of enforcing arbitration agreements and the difficulty of invalidating such agreements for unconscionability in New York State and the 2nd Circuit, courts at the center of commerce in the United States. It has been done but it is a Sisyphean task.⁴

The purpose of the FAA was to reverse judicial hostility to private arbitration agreements and “to place arbitration agreements on the same footing as other contracts.”⁵ This meant simply that such agreements should be enforced as written. As explained by the Supreme Court in *Southland v. Keating*, “We see nothing in the [Federal Arbitration] Act indicating that the broad principle of enforceability is subject to any additional limitations under state law than the generally applicable contract defenses of fraud, duress, or unconscionability.”⁶ In *Volt Information Sciences v. Leland*

them, little business would be conducted.

Another often-challenged provision calls for the parties to share arbitration fees and costs, which include the arbitrator’s compensation, but not attorney or witness fees. Fee-sharing agreements seem to impose an unwanted forum on claimants and at the same time place a barrier to participation in that forum. As we will see, courts appear to be quite concerned about access to the forum, particularly in employment disputes where arbitration is imposed as a condition of employment or continued employment. Arbitration clauses in consumer contracts are also an area of concern. Indeed a consumer arbitration case, *AT&T Mobility v. Concepcion*, is currently pending before the Supreme Court.

The Supreme Court has recognized that the cost of arbitration could be a potential barrier to access to the forum. In *Green Tree v. Randolph*,⁹ it said that “the existence of large arbitration costs could preclude a litigant ... from effectively vindicating her federal statutory rights in the arbitral forum.” However, it firmly indicated that the mere possibility of being precluded is not enough. “The ‘risk’ that Randolph will be saddled with prohibitive costs is too speculative to justify the invalidation of an arbitration agreement,” the Court said, explaining that “[t]o invalidate the agreement on that basis would undermine the ‘liberal federal policy favoring arbitration agreements.’” The

Court then applied the rule that a party challenging the arbitration clause must prove that her claims are “not suitable for arbitration.” As applied to a cost-sharing clause, the rule is that a party seeking to invalidate an arbitration agreement on the ground that arbitration would be prohibitively expensive “bears the burden of showing the likelihood of incurring such costs.”

Consequently, a challenger to an arbitration agreement cannot rest on the mere existence of a fee-sharing clause. Put another way, the fee-sharing clause does not render the arbitration agreement *per se* unconscionable.

The section below discusses the first of three cases that have addressed unconscionability challenges. Two involve challenges by employees and one by a franchisee against a franchisor.

The Brady Case

In *Matter of Brady v. Williams Capital Group*,¹⁰ all employees were required to sign an arbitration agreement as a condition of continued employment. The arbitration agreement provided for arbitration to be conducted under the American Arbitration Association (AAA) Employment Arbitration Rules. It also required the employee and employer to share arbitration costs. The fee-sharing provision was consistent with the cost provision then in the AAA rules. After the employee in this case was terminated, she commenced an AAA arbitration proceeding alleging discrimination against her former employer.

After the arbitration case was filed, the AAA rule on costs changed. The cost provision was revised to provide that in arbitrations under “Employer Promulgated Plans,” all arbitration fees and costs, including the advance payment of the arbitrator’s estimated compensation, are the employer’s responsibility. Applying the revised rule, the AAA billed the employer for the full amount of the arbitrator’s compensation but the employer refused to pay, saying that the original fee-sharing provision still applied. The AAA then canceled the arbitration for nonpayment of fees. The employee commenced a lawsuit in a New York State trial court, seeking to either compel the employer to advance all costs, or compel the AAA to enter a default judgment against the employer.

The court dismissed the case, holding that the parties’ arbitration agreement governed, not the revised AAA rule, and that agreement called for the parties to share fees. The court rejected the employee’s argument that requiring her to pay half of the arbitrator’s compensation was prohibitively expensive, given her salary while employed.

A majority of the intermediate appeals court

panel agreed with the trial court that the amended AAA rule did not supersede the parties’ arbitration agreement. However, it agreed with the employee that arbitration costs were so high as to discourage her from vindicating her statutory rights in arbitration. Relying on the state policy favoring arbitration, the appeals court decided to enforce the arbitration agreement without the cost-sharing provision (though that was not a remedy the employee sought.) Accordingly, it severed the cost-sharing provision and ordered the employer to advance the full amount of the arbitrator’s estimated compensation, “subject later to reallocation of those costs by the arbitrator.”

On appeal, the New York Court of Appeals highest court acknowledged that it had not previously addressed the relevant factors lower courts should consider in deciding when a cost-sharing provision in an employee’s arbitration agreement is enforceable. In analyzing this issue for the first time, the court first looked at the Supreme Court’s approach to the issue. It adopted from *Gilmer v. Interstate/Johnson Lane Corp.* the principle that “so long as the prospective litigant effectively may vindicate [his or her] statutory cause of action in the arbitral forum, the [FAA] will continue to serve both its remedial and deterrent function.”¹¹ Then, from *Green Tree Financial Corp.-Ala. v. Randolph*,¹² it accepted that financial ability could be an issue without rendering the arbitration agreement unenforceable.

The court also adopted the approach of the 4th Circuit in *Bradford v. Rockwell Semiconductor Systems*.¹³ *Bradford* determined that an employee’s financial ability to pay should be resolved by the district court on a case-by-case basis, after “focus[ing] on the claimant’s ability to pay the arbitration fees and costs, the expected cost differential between arbitration and litigation in court, and whether the cost differential is so substantial as to deter the bringing of claims.”

Applying these principles to the *Brady* facts, the court held that the employer and the trial court were correct: the parties’ arbitration agreement applied and could not be changed by a subsequent change in the AAA rules. Since a case-by-case approach was required, the case had to be remanded to the trial court for a hearing on whether the employee was financially able to share arbitration costs. The court directed the trial court on remand to consider, at a minimum: (1) whether the claimant could pay arbitration fees and costs, (2) the expected cost differential between arbitration and litigation, and (3) whether that differential is “so substantial as to deter the bringing of claims in the arbitral forum.” It also directed the trial court to make a

written record of the findings pertaining to the claimant's financial ability.

It left to the trial court's discretion the documentation required. But it did suggest two possible remedies if the cost-sharing clause is found unenforceable: One is to sever the cost-sharing clause, enforce the rest of the arbitration agreement, and require the employer to advance the full amount of arbitrator compensation. Alternatively, the court could offer the employee a choice between paying her share of arbitration costs ("accepting" the cost-sharing provision) and filing a lawsuit in court. However, the court left that decision to the trial court.

The court also discussed what could happen if, on the other hand, the trial court were to find that the employee has the financial ability to pay her share of arbitration costs. The court said that in that event, the cost-sharing provision was enforceable; therefore arbitration could proceed only if she were willing to make the payment.

Therein lies a Hobson's choice for the claimant. In both litigation and arbitration, unless the contract provides otherwise (or a statute allows for the recovery of attorney fees), parties are responsible for their own legal and associated expenses (known as the "American Rule"). A party who wishes to escape from an arbitration clause does not necessarily gain any significant advantage by prosecuting a legal action. It is not likely that total litigation costs will be lower, even though the parties do not have to pay for a judge to preside over the case or for a jury. Moreover, banking on a jury verdict for a higher award is unrealistic. In *Brady*, three courts rejected the plaintiff's application for an order compelling the employer to pay the full amount of the arbitrator's estimated compensation or compelling the AAA to enter a default judgment against the employer. None of the courts considered relieving the plaintiff of the arbitration provision.

The Harrington Case

Even when an employer has to advance the full amount of the arbitrator's estimated compensation, the ultimate costs of arbitration may be allocated by the arbitrator in the final award. In *Harrington v. Atlantic Sounding Co.*,¹⁴ a maritime case, Seaman Frederick Harrington filed a lawsuit under the Jones Act in federal court seeking damages from the ship owners for a back injury

suffered while working aboard the vessel. The defendants moved to compel arbitration pursuant to a post-injury arbitration agreement that Harrington signed in exchange for an agreement to advance funds for medical care and the arbitrator's compensation, "subject to later allocation by the arbitrator." The arbitration agreement granted the arbitrator authority to decide the proportion in which Harrington and defendants should bear arbitration costs. Harrington opposed the motion to compel arbitration, arguing that the arbitration agreement was unconscionable

because arbitration fees and expenses precluded him "from effectively vindicating his federal statutory rights in the arbitral forum." Applying New Jersey law, the district court agreed with Harrington, holding the arbitration agreement unenforceable.

New Jersey applies a "sliding scale" approach to unconscionability claims. Under this approach, an unconscionability claim can succeed when either procedural or

substantive arbitrability is greatly exceeded. Applying this analysis, the district court concluded that procedural unconscionability was greatly exceeded because, at the time that the defendants sent Harrington the arbitration agreement, he was in a substantially weaker bargaining position because, among other things: (1) he was "impaired" from medication, (2) he did not have an attorney, and (3) he was not advised to seek representation.

The district court also found misleading language in the arbitration agreement that gave the false impression to an unrepresented layperson that defendants were not subject to liability for any damages. The court ruled that this language was substantively unconscionable.

On appeal, the 2nd Circuit reversed. It rejected Harrington's argument that financial cost made the agreement procedurally unconscionable since he was not deprived of any legal rights. The court said the cost-sharing provision could only be unconscionable if the bargain was "'so one-sided' as to shock the court's conscience." That was not the case here.

The 2nd Circuit also found no substantive unconscionability, since the arbitration rules allowed the provider (the AAA) to defer or reduce arbitration costs in the event of extreme hardship and New York law allows an application to be made to the court to reduce or disallow any fee

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or expense it finds excessive or allocate it as justice requires.”¹⁵ But in any case Harrington’s lawyer agreed to advance all expenses, which the court presumed included arbitration costs. Therefore, the court vacated the district court’s decision and remanded the case to the district court for consideration of Harrington’s remaining contractual defenses.

Significantly, the 2nd Circuit did not allow Harrington to develop a record on remand on why “the fees would not be deferred or reduced in this case.” This was appropriate because the record showed that Harrington’s attorney agreed to take the case on a contingency, and this fact undercut his claim that he was “precluded from effectively vindicating” any of his rights.

Both the *Brady* and *Harrington* courts found the evidence insufficient to rule that the arbitration clause was unenforceable.

The Reid Case

*Reid v. Supershuttle International*¹⁶ involved franchisees who sought class action status and a declaration that the arbitration clause in the franchise agreement was substantively unconscionable and, therefore, unenforceable. The franchisees contended, without any proof whatsoever, that “the cost of litigating the claims asserted here will easily eclipse the \$1 million mark.” Thus, according to the plaintiffs, there was “no rational economic self-interest served by prosecuting their claims in arbitration due to such high cost.”

The court concluded that the franchisees had not proved the existence of an economic burden. It said, “to the extent that these claims are prohibitively expensive to litigate, it is not clear whether this expense results from the inherent

complexity of Labor Law claims or from the sheer number of individual plaintiffs and discrete claims involved.” It distinguished this case from *In Re American Express Merchants’ Litigation*,¹⁷ an antitrust case in which the plaintiffs met their burden by furnishing an expert opinion demonstrating that to prosecute an individual “tying” claim under the Clayton Act, an individual would have to spend hundreds of thousands of dollars for an expert economist’s antitrust study. Here, the court said that the franchisees marshaled far less “evidence.” It put quotation marks around that word to signal that it placed no value on the proof the plaintiffs offered.

The *Reid* case confirms that it is the complaining party’s burden to provide evidence to support the claim that an arbitration clause is invalid.

Conclusion

Declaring an arbitration agreement to be unenforceable is taken very seriously by courts. In deciding a challenge to an arbitration agreement based on state unconscionability law, courts will invariably cite the policy favoring enforcement of arbitration agreements. They will also assess whether the challenger submitted proof of procedural and substantive unconscionability. Speculation and possibilities will not be sufficient. As the cases discussed here demonstrate, courts will give short shrift to an unconscionability claim that is not supported by actual evidence.

Some courts measure unconscionability “in light of the mores and business practices of the time and place.”¹⁸ Furthermore, the conscience of courts is not easily shocked. As a result, there are likely to be few factual circumstances that will persuade a court that invalidating an agreement to arbitrate is justified. ■

ENDNOTES

¹ Federal Arbitration Act, 9 U.S.C. § 2.

² *Volt Information Sci. v. Leland Stanford Jr. Univ.*, 489 U.S. 468, 479 (1989).

³ See www.NCCUSL.org.

⁴ *Allied-Bruce Terminix Cos. v. Dobson*, 513 U.S. 265 (1995) (determining when a particular contractual agreement to arbitrate is enforceable is a matter to be decided under the general contract law of each state).

⁵ H. R. Rep. No. 96, 68th Cong., 1st Sess., 1 (1924), quoted in *Dean Witter Reynolds v. Byrd*, 470 U.S. 213 (1985). See also *Gilmer v. Interstate/Johnson Lane Corp.*, 500 U.S. 20, 24(1991).

⁶ 465 U.S. 1, 11 (1984).

⁷ *Supra* n. 2, 489 U.S. at 479.

⁸ 130 S. Ct. 2772 (2010) (reversing *Jackson v. Rent-A-Center West, Inc.*, 581 F. 3d 912, 9th Cir. 2009). The defen-

dant unsuccessfully contended that “certain elements” of the arbitration agreement (namely, equal sharing of fees and discovery provisions unfairly favoring the employer) rendered the entire arbitration agreement unconscionable under Nevada law. However, these elements received short shrift from the district court whose judgment the Supreme Court implicitly affirmed.

⁹ 531 U.S. 79 (2000).

¹⁰ 14 N.Y.3d 459 (N.Y. 2010).

¹¹ Cited *supra* n. 5.

¹² 531 U.S. 79 (2000). The 11th Circuit had held that the agreement to arbitrate posed a risk that respondent’s ability to vindicate her statutory rights would be undone by “steep” arbitration costs, and therefore was unenforceable. *Randolph v. Green Tree Fin. Corp.-Ala.*, 178

F.3d 1149 (11th Cir. 1999). The U.S. Supreme Court affirmed the first conclusion and reversed the second.

¹³ 238 F.3d 549 (4th Cir. 2001).

¹⁴ 602 F.3d 113, 126 (2d Cir. 2010).

¹⁵ N.Y. Civ. Prac. L. & R. 7513.

This section provides: “Unless otherwise provided in the agreement to arbitrate, the arbitrators’ expenses and fees, together with other expenses, not including attorney’s fees, incurred in the conduct of the arbitration, shall be paid as provided in the award. The court, on application, may reduce or disallow any fee or expense it finds excessive or allocate it as justice requires.”

¹⁶ 08-cv-4854 (E.D.N.Y. 2010).

¹⁷ 554 F.3d 300 (2d Cir. 2009).

¹⁸ *Sablosky v. Gordon Co.*, 73 N.Y.2d 133, 138 (1989).