NORTH CAROLINA
NEW HANOVER COUNTY

IN THE GENERAL COURT OF JUSTICE
SUPERIOR COURT DIVISION
04-CVS-2858

ADRIANA MCQUILLAN and SANDRA K. MATTHIS, on behalf of themselves and all other persons similarly situated,	)
Plaintiffs,	)
v.	)
CHECK 'N GO OF NORTH CAROLINA, INC.; CNG FINANCIAL CORPORATION; JARED A. DAVIS and A. DAVID DAVIS	)
Defendants.	)

PLAINTIFFS' MEMORANDUM OF LAW IN OPPOSITION TO DEFENDANTS' MOTION TO COMPEL ARBITRATION AND STAY PROCEEDINGS.

INTRODUCTION AND SUMMARY OF ARGUMENT

Adriana McQuillan and Sandra K. Matthis (collectively "Plaintiffs") bring this case on behalf of themselves and a putative class of North Carolina consumers who paid exorbitant interest charges on short-term "payday loans." Plaintiffs allege that defendants Check 'N Go of North Carolina, Inc., CNG Financial Corporation, Jared A. Davis and A. David Davis (collectively "Defendants" or "Check 'N Go") operated an illegal lending business in North Carolina in violation of the Consumer Finance Act, G.S. § 53-166(a)-(b); the Check Cashing Statute, G.S. § 53-276; and the Unfair Trade Practice Statute, G.S. § 75-1.1. Check 'N Go responded to these allegations by moving the Court to enforce provisions in its payday loan contracts prohibiting Plaintiffs from asserting their class-wide claims and instead requiring them to arbitrate only their *individual* claims.

Plaintiffs hereby oppose Check 'N Go's motion to compel individual arbitrations for two separate and independent reasons. First, the company's mandatory arbitration clause, by barring their class-wide claims, is an illegal exculpatory clause that violates public policy and is unconscionable under North Carolina contract law. Second, this arbitration clause also is unenforceable because it is part of an illegal payday lending contract that is void *ab initio*, and whose terms therefore never created binding obligations under North Carolina law. Third, the arbitration agreement forces customers to appear before a biased forum. Since Check 'N Go's arbitration clause is unenforceable on any or all of these grounds, the Court should deny its motion to compel individual arbitrations.

Check 'N Go's mandatory individual arbitration clause is governed by the same rules of North Carolina contract law that apply to all of the terms in these payday loan contracts. Under the Federal Arbitration Act ("FAA"), 9 U.S.C. §§ 1 *et seq.*, and North Carolina law, the law of

contracts governs whether there exists a valid arbitration agreement. *King v. Owen*, 601 S.E.2d 326, 327, 106 N.C.App. 246, 249 (2004). North Carolina law prohibits enforcement of exculpatory contracts that are gained through unequal bargaining power or are contrary to substantial public interests. *See Fortson v. McClellan*, 131 N.C. App. 635, 636, 508 S.E.2d 549, 551 (1998). Likewise, North Carolina law also prohibits enforcement of contracts that are unconscionable because of a lack of meaningful choice by one party together with terms that are unreasonably favorable to the other. *See State Farm Mutual Automobile Ins. Co. v. Atlantic Indemnity Co.*, 122 N.C. App. 67, 73, 468 S.E.2d 570, 573 (1996). Check 'N Go's mandatory individual arbitration clause runs afoul of both of these prohibitions because it was imposed against Plaintiffs and payday loan borrowers without any opportunity for negotiation and strips them of their only economically viable legal remedy by prohibiting class-wide claims, but leaves Check 'N Go free to vindicate all of its legal claims.

Moreover, under North Carolina law, contracts made for an illegal purpose in violation of controlling statutes are void as against public policy, and therefore can never be given legal effect. As a matter of North Carolina law, parties cannot give assent to contracts entered into for an illegal purpose. Here, these high-interest payday loan contracts are illegal under several North Carolina statutes, including the Consumer Finance Act and Unfair Trade Practice Statute. If these payday loan contracts are illegal and void, then none of their terms—including their arbitration clauses—can ever have legal effect because neither plaintiffs nor Check 'N Go could have assented to Check 'N Go's illegal purpose. Therefore, the illegality of Check 'N Go's entire payday loan contract is an additional basis for this Court to deny the motion to compel individual arbitration.

Check 'N Go's arbitration clause is unenforceable for a third reason. In North Carolina, it is unconstitutional for a decision maker to have a substantial financial interest in the outcomes of her or his decisions. Many courts looking at analogous cases have held that if it would be unconstitutional for a government to impose a biased decision maker upon individuals, it should also be unconscionable for a company to impose a similar system upon an individual consumer. Unlike most other lenders, who give consumers a choice among arbitration companies, Check 'N Go has elected to force its customers to submit all of their claims to a single bad actor firm – the National Arbitration Forum ("NAF"). NAF, as set forth in dozens of documents from its own files, as well as a large number of sworn declarations attached to this brief, is severely biased in favor of lenders and against consumers.

Finally, there is nothing in federal arbitration law under the FAA that preempts these principles of North Carolina contract law and compels a contrary result. First, the FAA contains an express "savings clause" that subjects arbitration clauses to generally applicable state laws governing the formation and revocation of contracts. *See First Options of Chicago, Inc. v. Kaplan*, 514 U.S. 938, 944 (1995); *Doctor's Associates, Inc. v. Casarotto*, 517 U.S. 681, 687 (1996). Second, the FAA's preemption of state laws was enacted for the purpose of singling out arbitration clauses and subjecting them to less favored treatment than other contracts, *see id.* at 686-87, has no application here because North Carolina's public policy rule against exculpatory clauses, its doctrine of unconscionability, and its prohibition against enforcing terms in illegal contracts are all generally applicable rules. Finally, U.S. Supreme Court cases applying the FAA are consistent with North Carolina law against exculpation in holding that the arbitral forum must allow parties to effectively vindicate their claims. *See, e.g., Gilmer v. Interstate/Johnson*

Lane Corp., 500 U.S. 20, 26 (1991).

Therefore, under these generally applicable rules of North Carolina contract law, Check 'N Go's mandatory individual arbitration clause is unenforceable. The motion to compel individual arbitrations should be denied.

STATEMENT OF FACTS

I. BACKGROUND ON PAYDAY LENDING

A. Check 'N Go's Payday Lending Business Model

Plaintiffs are borrowers of payday loans from Check 'N Go offices in North Carolina. Payday loans are short-term loans provided for a set fee that translates into an extremely high interest rate. Under Check 'N Go's form of payday lending as practiced in North Carolina, a customer in need of a loan writes a personal check for an amount of $500 or less, and obtains a promise that the check will not be presented for payment until a short time in the future, typically 14-30 days. Am. Compl., ¶ 15. The customer is then given the amount of the check, minus a substantial finance charge. For example, if a customer wants a loan for $400, the customer writes a check for $472, with the extra $72 representing the finance charge. When calculated out over the course of a year, the finance charge typically works out to an annual percentage rate of interest of 400% or more. At the end of the short-term loan period, the customer then must pay back the total amount of the loan to get the check back, or, if they cannot pay it back," roll over" the loan into a new loan by paying an additional finance charge. *Id.* Thus, a customer borrowing $200 can end up paying many times that amount in interest charges without ever paying off the original loan principal.

Check 'N Go's entire payday lending business is based on a uniform practice of getting

borrowers to write checks that Check 'N Go has reasonable grounds to believe are not covered, at the time of the making of the check, by adequate funds in the maker's checking account. This practice violates N.C. Gen. Stat. §14-107(b) which makes it unlawful:

> for any person, firm or corporation to *solicit* or to *aid and abet* any other person... to draw, make, utter or issue and deliver to any person, firm or corporation, any check or draft on any bank or depository for the payment of money or its equivalent, being informed, knowing *or having reasonable grounds for believing* at the time of the soliciting or the aiding and abetting that the maker or the drawer of the check or draft has not sufficient funds on deposit in, or credit with, the bank or depository with which to pay the check or draft upon presentation.
>
> (emphasis added).

The effect of the consumer not having funds in the checking account to keep the check from bouncing if deposited, gives rise to one of the worst evils of payday lending-- rollovers. Payday lenders make most of their profits through particular borrowers' repeated borrowings. Consumers become fearful of criminal prosecution if they do not pay back the loan (*See* McQuillan Affidavit, Exhibit 1A and Matthis Affidavit, Exhibit 1B), and become trapped in a rollover debt cycle when they must continue renewing or repeating the loan transaction. Check 'N Go's practice of requiring its borrowers to write checks "knowing or having reasonable grounds for believing" there are insufficient funds to cover the checks has additional negative and perverse effects. Failure to repay the loan (or roll over the loan) leads to bounced check fees from the consumer's bank, negative credit ratings on specialized databases, possible loss of a bank account, and difficulty in opening a new bank account if the borrower has a record of bouncing checks. Taking the borrower's personal check in connection with the payday loan deprives the customer of any effective opportunity to present defenses to the loan. This practice gives Check 'N Go enormous leverage over the consumer in collecting the payday debt.

The named plaintiffs have obtained payday loans of $500 or less from Check 'N Go. The loan were for periods of 14-30 days. Am. Compl., ¶ 38. The plaintiffs were required to pay hefty finance charges as part of the loan agreement. For instance, Andrea McQuillan paid $501.50 to obtain a $425 loan, and paid $354 to obtain a $300 loan. *Id.*, ¶ 40. To obtain a loan of $200 dollars, Ms. Matthis was instructed to write a personal check for $236. To obtain a loan of $225, Ms. Matthis was instructed to write a personal check for $265.50. The charges on such loans ranged translated into an annual percentage ranged from 199% to 469.29%. *See* id, ¶ 49..

B. The Illegality of Payday Lending

Prior to 1997, payday lending was illegal in North Carolina. A 1992 North Carolina Attorney General's opinion made it clear to Check 'N Go and other payday lenders that payday lending violates the North Carolina Consumer Finance Act, N.C. Gen. Stat. § 53-164 *et seq.*, and North Carolina criminal law, N.C. Gen. Stat. § 14-107(b). *See* 60 N.C.A.G. 86 (1992). In 1997, the North Carolina General Assembly acted to temporarily legalize payday lending, while at the same time heavily regulating the activities of the industry. Act of Aug. 18, 1997, 1997 N.C. Sess. Laws 391 (codified as amended at N.C. Gen. Stat. §§ 53-275–53-289 (1999) (repealed 2001)). The purpose of the law was to prevent some of the industry's most abusive lending practices, such as excessive fees and "rollovers" that turned a short-term loan into a revolving line of credit, while at the same time providing access to small amounts of short-term credit for emergencies. Scott A. Schaaf, *From Checks to Cash: The Regulation of the Payday Lending Industry*, 5 N.C. Banking Inst. 339, 359-62 (2001).

The statute included a sunset provision, which allowed the law to expire on July 31, 2001. § 3, 1997 N.C. Sess. Laws 391. However, the General Assembly also indicated its intent to

remove the sunset once the industry demonstrated its good faith willingness to comply with the regulations and provided there was "no evidence of excessive complaints by consumers or unfair and deceptive trade practices" by lenders. § 2, 1997 N.C. Sess. Laws 391; Schaaf, 5 N.C. Banking Inst. at 360-61.

Payday lenders failed their probationary period. Numerous lenders ignored the prohibitions against rollovers and excessive fees. Schaaf, 5 N.C. Banking Inst. at 362. Lenders also found ways to circumvent the 31-day limit imposed by the statute. *Id.* Ultimately, the General Assembly determined that payday lenders were unwilling to cooperate with reasonable regulations. After initially extending the sunset by one month, the General Assembly refused to renew authorization for payday lending. Legal authority for payday lending expired on August 31, 2001.

Check 'N Go had ample warning of the law's sunset date, as on July 31, 2001 and again on August 30, 2001, the North Carolina Commissioner of Banks informed all payday lending businesses in the state that the law was set to expire and no legal authority would exist for payday lending to continue in the state. *See* Banking Commissioner Hal D. Lingerfelt's Memo of July 31, 2001 and August 30, 2001, attached as Exhibits 2 and 3. Nevertheless, Check 'N Go has continued to operate its payday loan business and to offer payday loans to North Carolina residents after August 31, 2001, notwithstanding the statute's expiration.

In order to evade the requirements of North Carolina law, Check 'N Go adopted an "agency model" for its payday lending operations in North Carolina. Under this model, Check 'N Go entered into an arrangement to a series of "rent a charter" arrangements, including with Brickyard Bank and County Bank of Rehoboth Beach, an FDIC insured, state-chartered bank,

whereby Check 'N Go purports to act as an agent of the banks. Check 'N Go believes that by entering into this arrangement, it is no longer subject to North Carolina law and can offer payday loans free and clear of any state regulation.

C. Check 'N Go's Arbitration Clause

The entire payday loan model is composed of usurious interest terms and an exculpatory arbitration provision. As stated above, Check 'N Go charges triple digit interest rates on its payday loans. A second essential characteristic of Check 'N Go's business model is the inclusion in its loan agreements of a binding mandatory arbitration clause that deprives borrowers of the right to pursue a class action remedy, either in court or in arbitration, and that requires all arbitrations to be conducted by the National Arbitration Forum (NAF). In order to obtain a payday loan, plaintiffs were required to sign loan agreements drafted and provided by Check 'N Go as a condition of obtaining the loan. Included in those loan agreements were clauses requiring plaintiffs to give up their right to a jury trial and to submit any disputes with Check 'N Go to binding mandatory arbitration. *See* McQuillan Arbitration Agreement, attached as Exhibit 4. The arbitration clause written by Check 'N Go forbids plaintiffs from acting as a representative, private attorney general or as a member of a class action. *See id.* Check 'N Go's arbitration clause prohibits anything other than arbitration on an individual basis, and specifically prohibits class proceedings of any kind, either in court or in arbitration. Check 'N Go also designated the National Arbitration Forum ("NAF") as the exclusive arbitrator for all disputes. *See id.* Under the terms of the loan agreement, the plaintiffs cannot choose, or in any way participate in the choosing of the company that will arbitrate future disputes.

II. FACTS RELATING TO THE ENFORCEABILITY OF DEFENDANTS' ARBITRATION CLAUSES

A. There is a Vast Disparity of Bargaining Power Between the Wealthy and Sophisticated Defendants and the Economically Desperate Plaintiffs

Check 'N Go is a highly profitable and sophisticated corporation. It operates more than 1,100 stores in 29 states, including 64 stores in North Carolina alone. *See* excerpts from Check 'N Go website, attached at Exhibit 5. Check 'N Go's annual revenues have exceeded $12.9 million. See Affidavit of Robert E. Kassner in Support of Defendants' Notice or Removal, attached as Exhibit 6. Check 'N Go has retained the services of some of the most prominent attorneys in both North Carolina and the nation, it is advised by prominent accountants and is represented by numerous well-heeled lobbyists. Check 'N Go prides itself as an industry leader. *See id.*, ¶ 5.

The Plaintiffs, by contrast, are far from economically powerful. In fact, for the times they were borrowing from Check 'N Go at an exorbitant interest rate, they are most accurately described as economically desperate. *See* McQuillan and Matthis Affidavits, Exhibit 1A and 1B. Studies of payday lending consumers confirm the circumstances of the named plaintiffs here, showing that most payday borrowers face severe financial pressure that make payday loans an economic necessity. *See, e.g.*, Jean Ann Fox, *"A Portrait of the Small Loan Consumer": A Review of Existing Research on Payday Loan Customers*, May 17, 2003, at 13 (attached); *see also Smith v. Steinkamp*, 318 F.3d 775, 776 (7th Cir. 2003) (noting that a payday borrowers are "poor or improvident borrowers who have no savings or credit and run out of living expenses before they receive their weekly or biweekly paycheck," and that they "*must* be desperate" if they are willing to agree to such high interest rates).

B. Check 'N Go's Arbitration Clause Is A Contract of Adhesion

Check 'N Go's arbitration clause is a standard form document that was drafted by Check 'N Go. It was presented to each of the plaintiffs as part of an agreement that they were required to sign as a condition of obtaining a payday loan. No employee of Check 'N Go explained to them that the loan agreements contained an arbitration clause, that the arbitration clause required them to give up their right to go to court, or that the arbitration clause prohibited plaintiffs from pursuing their claims on a classwide basis. *See* McQuillan and Matthis Affidavits, Exhibits 1A and 1B. The plaintiffs were not given any opportunity to negotiate different terms, and were hurried through the loan process so quickly that they did not have time to read the loan agreements thoroughly before signing them. *Id.* In short, the arbitration clause was presented on a "take-it-or-leave-it" basis.

C. All of the Other Payday Lenders in North Carolina Also Require Borrowers to Submit to Mandatory Pre-Dispute Binding Arbitration Clauses that Ban Class Actions

Check 'N Go is not unique among North Carolina payday lenders in requiring its customers to submit their claims to individual arbitration. Indeed, as shown in Exhibit 7, these clauses are ubiquitous throughout this industry in North Carolina, and they all prohibit consumers from proceeding on a class action basis. *See also* Robert W. Snarr, Jr., Supervising Examiner, Federal Reserve Bank of Philadelphia, *Am. Compliance Corner*, Spring 2002, at CC2 <*available at* http://www.phil.frb.org/src/srcinsights/pdf/ccq1.pdf> ("The inclusion of mandatory arbitration clauses within payday loan contracts appears to be standard operating procedure among payday lenders and banks that partner with payday lenders to originate payday loans.") (Attached). In response to discovery requests, Check 'N Go was unable to identify any payday

lender which does not use an arbitration clause in connection with their loans. See Defendants' Responses and Objections to Plaintiffs' Second Set of Interrogatories, ¶ 19, 8. The bottom line is that it would be extremely difficult, if not impossible, for a North Carolina consumer to obtain a payday loan without signing a contract that contains a pre-dispute binding mandatory arbitration clause prohibiting class actions.

D. Check 'N Go Presented Its Arbitration Clause to Plaintiffs In A Manner that Made It Very Difficult to Understand

Check 'N Go's arbitration clause was drafted in a manner that makes it unreadable for individuals seeking payday loans. Ms. Beth Weir, an expert on readability, conducted an analysis of the arbitration clause that Adriana McQuillan was required to sign in order to obtain a payday loan from Check 'N Go. Affidavit of Beth Weir., ¶ 4 (Exhibit 9). In her attached expert affidavit Weir concluded that "the vast majority of Americans would have difficulty comprehending the arbitration agreements I assessed." *Id.*, ¶ 38. Based on her analysis, Weir stated that only an individual with the ability "to read well beyond the high school level" would be able to comprehend Check 'N Go's arbitration clause. *Id.*, ¶ 6. Weir found certain sentences of the arbitration clause, such as the 168-word first sentence of the Check 'N Go's arbitration clause, to be so long and complex so as to render them "essentially not comprehensible." *Id.*, ¶ 15 (concluding also that one would have to read at a "69th" grade level to understand the sentence). Weir found that the arbitration clause registered a score of "very difficult" and would require a 16th grade reading level for comprehension. Unfortunately, the average American only reads at between a seventh and ninth grade level, and fewer than one in five North Carolinians and only one in five Americans can read at a high school level or beyond. *Id.*, ¶¶ 6, 40-41.

Not only does Check 'N Go's arbitration clause include a number of difficult words, but several important terms in the arbitration clause, such as the term "servicer" (apparently referring to Check 'N Go) are undefined and do not appear in conventional dictionaries. *Id.*, ¶ 31. Factors like this, as well as the cramming of multiple complex ideas into a single sentence, *see id.*, ¶¶ 32-34, caused Weir to conclude that "a reader is likely to have even more difficulty in comprehending the arbitration agreements than the readability formula scores would indicate." *Id.*, ¶ 30.

By contrast, Weir found that the text contained on Check 'N Go's website that it uses to market its loan products to potential customers is written at a much simpler level than the arbitration clause. *Id.*, ¶¶ 17-18. Accordingly, Check 'N Go knows how to make itself understood when it wants to acquire a customer's business, and how to prevent itself from being understood when it does not want its customers to know the rights they are being forced to sacrifice.

E. Plaintiffs' Claims May Not Realistically Be Pursued on An Individual Basis

The class action ban in Check 'N Go's arbitration clause operates as an exculpatory provision because payday borrowers will not be able to pursue their claims on an individual basis. Because the stakes of an individual arbitration on behalf of a payday borrower are so small, no attorney will represent a payday borrower absent the availability of classwide relief. In his attached expert affidavit, Stuart Rossman, the Director of Litigation at the National Consumer Law Center, opined that an aggrieved consumer bringing these actions as an individual would not be able to obtain private legal counsel, and would be very unlikely to obtain representation from a legal aid program. He reasoned that:

> The costs associated with preparing and litigating the claims asserted in the Complaints, particularly against defendants commanding significant resources, could not be recovered through a contingency fee. The cost of representation based upon an hourly fee, similarly, would be greater than any potential recovery the individual Plaintiff might seek. Because of the dramatic cuts in funding, few legal aid programs have the resources to address this type of case.

Rossman Affidavit, Exhibit 10, ¶ 16. Also atttached hereto are affidavits from seventeen different private attorneys practicing throughout North Carolina, with experience representing consumers, and one attorney from Georgia with significant experience litigating claims involving payday lending. *See* Exhibits 11 (A-R). All eighteen private attorneys stated that they would not have represented the named Plaintiffs in individual actions, either in court or in arbitration, because the small stakes relative to the time and expense required to pursue the case made it a financially infeasible alternative. *See id.* Those attorneys also attested that they would not take the named Plaintiffs' cases on an individual basis notwithstanding the availability of statutory attorneys fees, because the chance of prevailing in the dispute, along with the chance of actually receiving attorneys fees if they prevail, is too uncertain to justify taking the case. *See id.* Thus, the attorneys concluded that even if the named Plaintiffs had valid claims, if they were required to proceed on an individual basis, either in arbitration or in court, "it is overwhelmingly likely that few, if any, of the people in the proposed class would be able to find an attorney to represent them on a contingency basis, and that it would be foolhardy for any consumer to retain counsel to pursue the relatively small amounts on an hourly basis. If those claims can only be pursued on an individual basis, my opinion is that very few – and probably, none – of the people in the proposed class have any realistic chance of obtaining a remedy for the conduct described in the complaints, no matter how strong their claims are." *Id.*

Not only would the named Plaintiffs find themselves unable to retain a private attorney to represent them on an individual basis, they also would not be able to obtain representation from legal aid and legal services attorneys. Affidavits from four legal aid and legal services attorneys state that legal aid offices are woefully understaffed and underfunded, and that they simply do not have the time or resources to be able to represent aggrieved payday borrowers. *See* Exhibits.12-A-D. While the likelihood that any consumer will be able to receive legal assistance from a legal aid office in North Carolina is small, it is downright minuscule for payday borrowers, who occupy a lower case intake priority than many other consumers, particularly those facing home foreclosures. *See* Affidavit of Andrea Bebber, ¶¶ 13-18; Hausen Affidavit, ¶ 10. Moreover, most payday borrowers have a level of income that makes them ineligible for traditional legal assistance programs. *See* Affidavit of George Hausen ¶ 10. Furthermore, there is no formalized system of *pro bono* representation in North Carolina for individuals above the legal aid income guidelines, making it highly unlikely that payday lending borrowers will be able to obtain representation. *See* Hausen Affidavit ¶ 16 Therefore, absent the opportunity to pursue a class action, the named Plaintiffs have no legal recourse at all for their injuries.

Check 'N Go's attempt to use its arbitration clause banning class actions as an exculpatory device has been successful. Since 1997, not a single Check Into Cash customer has initiated an individual arbitration against it. *See* Defendants CNG Financial Corporation and Check 'N Go of North Carolina, Inc.'s Objections and Responses to Plaintiffs' Second Set of Interrogatories and Request for Production of Documents, ¶ 20.

F. Plaintiffs Allege that the Single Purpose Contract At Issue Here is Illegal and Violates a Number of North Carolina Statutes

The sole purpose of Defendants' contracts with Plaintiffs was to provide for payday lending transactions. Plaintiffs allege that these transactions violate a number of North Carolina statutes including the North Carolina Consumer Finance Act, G.S. § 53-166(a) and (b); the North Carolina Unfair Trade Practice Statute, G.S. § 75-1.1; and the North Carolina Check Casher Act, G.S. § 53-276. Because these contracts are alleged to have solely an illegal purpose, they are thus alleged to be void *ab initio* under North Carolina contract law. Accordingly, defendants' payday loan contracts are not contracts at all, and no legally cognizable or binding contractual relationship (including any supposed agreement to arbitrate) ever came into existence in the first place.

G. The Payday Lending Industry Is a Heavily Regulated Industry

In North Carolina, a number of laws promoting the state's interest in protecting consumers regulate payday lenders. In fact, former N.C. Gen. Stat. 53-275 is only the latest chapter in North Carolina's nearly 80-year struggle to control payday lending. "Payday lending" is the same practice formerly known as "wage buying" or "salary buying." Christopher L. Peterson, *Truth, Understanding, and High-Costs Consumer Credit: The Historical Context of the Truth in Lending Act*, 55 Fla. L. Rev. 807, 810, 850-55 (2003). Early payday lenders acquired the nickname of "wagebuyers" or "salary buyers" because they sought to evade usury laws by claiming to be "buying wages" or salaries. *Id.* at 810, 852; Schaaf, 5 N.C. Banking Inst. at n.3. The term "loan shark" was originally coined to describe these early payday lenders. *Id.*

The North Carolina General Assembly first acted to restrain the practice of "wage buying" in 1927, when it amended the state's usury statute to clarify that loans "upon any assignment or sale of wages earned or to be earned" were subject to North Carolina's usury law

prohibiting interest in excess of 6%. 1927 N.C. Public Laws, c. 72. (current version at N. C. Gen. Stat. § 14-391 (2003), amended by N.C. Gen. Stat. §§ 53-164 et. seq. (2003) (exempting persons licensed under Consumer Finance Act)). Furthermore, though the penalties for usury normally entailed only the forfeiture of interest charged, North Carolina imposed criminal penalties for wage-buying. *Id.*

However, due to payday lenders' practice of withholding promissory notes, receipts or other evidence that could prove usury, *see* William Hays Simpson, *The Loan Shark Problem in the Southeastern States*, 19 Law & Contemp. Probs. 68, 69 (1954), the clarification did little to curb the practice of wage buying, *Proposals for Legislation in N.C.*, 11 N.C. L. Rev. 51, 74 (1932). Payday lenders also evaded usury laws by cashing checks that were given solely as evidence of a loan. *See Melton v. Rickman*, 225 N.C. 700 (1945). When the check bounced, as the lender knew it would, the lender used the threat of criminal prosecution to force collection of usurious interest. *Id.* Justice Seawell referred to the payday lending industry as "a nefarious business" employing "vicious small loan practices." *Id.*, (Seawell, J., dissenting).

As a result, the General Assembly passed a law in 1935 prohibiting the assignment of future wages without the express, written agreement of the employer. 1935 N.C. Public Laws, Ch. 410; *Morris v. Holshouser*, 220 N.C. 293, 298, 17 S.E.2d 115, 119 (1941) (statute limiting the assignment of unearned wages was enacted "to restrain the activities of those . . . engaged in the business of buying at a discount the unearned wages of employees.")

When this regulation too failed to restrain payday lenders from evading the usury laws--in 1940, the average annual interest rate on small loans ranged from 279% to 444%, Simpson, 19 Law & Contemp. Probs. at 74--the General Assembly, "seeking a solution to the loan shark

problem enacted a law [in 1945] which placed the loan agencies under the supervision of the Commission of Banks and provided that a fee of $2.50 could be charged in addition to 6 per cent interest per annum on installment loans of $50 or less." *Id.* at 75.

The new law specifically included wage buyers in the definition of loan agencies and brokers, N.C. Gen. Stat. §§ 53-164 (1950), and prohibited the "rollover" fees that typically chained borrowers to a treadmill of debt, § 53-165 (1950); Simpson, 19 Law & Contemp. Probs. at 75. The State Banking Commission issued regulations pursuant to its new authority that required loan agencies and brokers to maintain certain records, report regularly to the Banking Commission and "prohibited the dividing of loans and the charging of excessive fees." Simpson, Law & Contemp. Probs. at 75.

Rather than comply with the law, payday lenders responded by instituting what the Commissioner of Banks, Gurney P. Hood called "a legalized accident and health insurance racket." *Id.* at 76. Loan agencies began to require life insurance on each loan. *Id.* at 75. Eventually, payday lenders required borrowers to purchase health insurance and accident insurance as well, *id.*, and it became "almost impossible to obtain a loan at the vast majority of the [loan] agencies without buying insurance," *id.* at 77.

Often, the insurance premiums equaled or even exceeded the full amount of the loan. *Id.* at 76. According to a report by the State Banking Commissioner, in 1951, 43% of small loan agencies' total income came from insurance commissions. *Id.* at 77. Frequently, the company never even wrote the insurance policy once it collected the premium. *Id.* at 78. Furthermore, because the Banking Commission's authority did not extend to the regulation of insurance, there was little the Commission could do to curb these abusive practices. *Id.* at 78.

In response to payday lenders' flagrant violation of the law, the General Assembly passed the North Carolina Small Loans Act in 1955 "to provide additional protection to borrowers from small loan agencies." Small Loans Act, 1955 N.C. Sess. Laws c. 1279 (codified at N.C. Gen. Stat. § 53-164 et. seq. (1960) (repealed)). The Small Loans Act specifically prohibited the industry's abusive insurance practices and provided that any insurance activity was subject to the Commissioner of Insurance. N.C. Gen. Stat. § 53-166 (1960) (repealed).

By the end of the 1950s, it had become clear that the attempt to control payday lending through legislation and regulation was a failure. The lenders simply would not obey the law. Each regulation met with a new attempt to evade the law. 33 Op. Att'y Gen. 24 (1955) (small loan agencies may not charge fees, directly or indirectly, by entering into "kickback" arrangements with notary publics); 34 Op. Att'y Gen. 20 (1958) (small loan agencies may not repeatedly refinance loans such that interest is "pyramided" and the same lender is charged the 6% interest limit multiple times in the same borrowing period on the same loan).

Ultimately, the General Assembly decided to start from scratch. It scrapped all existing small loan laws and passed the significantly more comprehensive North Carolina Consumer Finance Act in 1961. 1961 Session Laws, c. 1053 (codified as amended at N.C. Gen. Stat. §§ 53-164 et. seq. (2003)); *see also Usury Law in North Carolina*, 47 N.C. L. Rev. 761, 767 (1969). The Consumer Finance Act exempted loans under $600 (now $3000) from the state's usury limits, provided the lenders are licensed and comply with provisions of the Act and any regulations promulgated by the Commissioner of Banks. N.C. Gen. Stat. § 53-166 (1965), *amended by* § 53-166 (2003). Given payday lenders' history of evading the law, the Act further specified that its provisions apply to "any person who seeks to avoid its application by any

device, subterfuge or pretense whatsoever." N.C. Gen. Stat. § 53-166(b) (1965).

Under the Consumer Finance Act, payday lending remained illegal in North Carolina. Despite the industry's resurgence in the 1990s, payday lending is illegal today. The Commissioner of Banks recently instituted a contested case proceeding against Advance America, one of Check 'N Go's counterparts. *See In re Advance America*, Amended Notice of Hearing, Exhibit 13.

H. Facts Pertaining to the National Arbitration Forum

NAF is a very secretive company, resisting discovery and insisting upon sweeping secrecy orders whenever it can. In a companion case to this one, for example, also brought before this Court, NAF has vigorously resisted all discovery, including refusing to appear for a properly scheduled deposition. *See* Affidavit of Richard Fisher, Exhibit 14 hereto. Nonetheless, from documents produced in other cases (generally after extensive stonewalling and lengthy delays, and only after getting court orders in Minnesota requiring the organization to appear), and from plaintiffs' own investigation, some important facts have come to light about this secretive organization that would replace the civil justice system.

NAF is a for-profit organization. As of a few years ago, it operated with twenty-six employees all employed out of a small office in Minnesota. *See* Dep. of Edward C. Anderson taken in the case of *Toppings v. Meritech*, excerpts from which are attached as Exhibit 15 hereto, at 16-17. Pursuant to NAF rules, arbitrators are paid on a fee-per-case basis. That is to say, arbitrators only get paid if they hear a case, and they get paid more if they handle more cases. *See* id. at 19-20. Under the NAF Code of Procedure, parties must select an arbitrator from a list of individuals approved and pre-selected by NAF, *see* Anderson Depo. in *Toppings*, Exhibit15 at

24, unless both parties agree to depart from the NAF list.[1] In the "vast majority" of cases, the NAF's director ends up selecting the candidates for arbitrators in NAF cases. *See* Anderson Depo. in *Hubbert*, Exhibit 16 hereto, at 56-57.

1. Facts Relating to NAF's Statements to Lenders

NAF has written a series of letters and published a series of advertisements soliciting business from lenders, promising to conduct arbitrations under a variety of rules that differ from the practice in court and from those of other arbitration service providers. A number of these promises favor the lenders' interests and place consumers at a disadvantage. In the interests of space this brief will merely forth an illustrative sample of such statements.

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[1] On another occasion, Mr. Anderson was asked "If [arbitrators] don't get selected [to hear a case], they don't get paid; correct?," and he answered "That's correct." *See* Dep. Edward C. Anderson, taken in the case of *Hubbert v. Dell*, excerpts of which are attached as Exhibit 16 hereto.

a) One NAF advertisement urging corporations and lenders to draft mandatory arbitration clauses naming the NAF as the arbitrator promises that NAF is "the alternative to the million dollar lawsuit."[2] Before an NAF arbitrator actually hears the facts of any dispute, NAF is apparently proclaiming that its mission is to make sure that no claimant will receive $1 million for their legal claims.

b) In another advertisement, NAF promises potential corporate clients that it will "make a positive impact on [their] bottom line." Exhibit 18.

c) In an article written for in house corporate lawyers, NAF's Director Ed Anderson has boasted that NAF has a "loser pays" rule that requires any consumer who does not win his case to pay the finance company's attorney's fees. See *ADR – Organizations; Do An LRA: Implement Your Own Civil Justice Reform Program NOW*, THE METROPOLITAN CORPORATE COUNSEL (Aug. 2001) ("The rules of the National Arbitration Forum allow the arbitrator to award the prevailing party the cost of the arbitration, including attorneys' fees. . . . There is no such thing as a 'no risk' arbitration for either side.").

d) In one letter, an NAF executive promises a lawyer who specializes in defending finance companies that if the lawyer's clients will require their consumers to submit to NAF arbitration, that his clients will not need to worry about the plaintiffs' "class action bar" in lawsuits arising out of the Y2K computer issue. *See* Letter from Roger Haydock to Alan Kaplinsky, Exhibit 19 hereto. Consider the approach embodied in this letter. The letter

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[2] This document is one of many that NAF produced in the *Toppings* case pursuant to a subpoena, from its own files, and that were admitted into evidence and made part of the court record in that case. They were also part of the record on appeal, where the state supreme court struck down an NAF clause as unconscionable. *Toppings v. Meritech Mortgage Services, Inc.*, 569 S.E.2d 149 (W. Va. 2002). The document is attachment 1 to Exhibit 17 hereto.

characterizes an area of litigation as a battle between "the class action bar" and lenders. The letter – written by the top person in the NAF – clearly takes the lenders' side in this battle, and urges defense counsel for lenders to use the NAF as a means of foiling "the class action bar."

e) In correspondence from NAF 's Director of Development, Curtis D. Brown, to a potential NAF client, NAF promised that "By adding arbitration language to your contracts, the [NAF's] national system of arbitration lets you minimize lawsuits, and the threat of lender liability jury verdicts." Exhibit 17 hereto, Attachment 2. The correspondence also included a "starter kit," to help the lender draft an arbitration clause that would be particularly likely to be enforced and help limit its liability. This was then followed by another solicitation promising to limit arbitration awards to the amount claimed. *Id.*

f) In another letter, Leif Stennes, a policy analyst for NAF, wrote a lender's in-house counsel that "There is no reason for Saxon Mortgage, Inc. to be exposed to the costs and the risks of the jury system." Exhibit 17 hereto, Attachment 3.

g) A memo attached to a letter from Mr. Anderson to a client explained to NAF's potential clients why its rules banning class actions are important: "In the court system, financing transactions are always at risk for Class Action treatment. . . ." It went on: "Most often, the claims of class action plaintiffs' lawyers are based on printed or computer-generated documents or standard procedure manuals, which leave little room to argue against 'commonality' or 'typicality.'" Exhibit 17, Attachment 4. In other words, even where any court would recognize that class action treatment was appropriate and superior to individual actions, the NAF was assuring the lender that it would not permit such

handling.

h) NAF issues a publication entitled "Domain News: that touts when its arbitrators rule for famous people in disputes over internet domain names. *E.g., Johnny Unitas Wins Another One*. 2 Domain News, Vol. 4 at 2; *Master of Domains: metallica org*, 1 Domain News, Vol. 7 at 1. Exhibit 17, attachment 5. Plaintiffs know, of no other arbitrator, and certainly no court, that affirmatively publicizes decision favoring one party over the other.[3]

i) In another article, Mr. Anderson revealed the extent of his zealotry for using arbitration as "tort reform." In this article, he criticized the Congress for not enacting "civil justice reform," i.e., limits on damages in medical malpractice suits, and argued that in the mean time all hospitals, medical professionals and airlines should adopt binding arbitration clauses to help with "the war on terrorism." Edward C. Anderson, "Civil Justice Reform -- Legal Service Providers; Civil Justice Reform and Homeland Security," Metropolitan Corporate Counsel, November 2002, at 54.

B. Facts Relating to NAF's Relationship With Lenders

NAF has a symbiotic relationship with lenders, upon whom it depends for its financial survival. One piece of evidence for this fact comes from NAF's own advertisements and letters. One NAF advertisement labeled "Professionals and the National Arbitration Forum," consists of a list of favorable quotes, all of which come from attorneys or officials affiliated with lenders.

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[3] *See also* Affidavit of Michael Geist, Exhibit 20 hereto, at ¶ 14 ("During my research, I was on NAF's media distribution list. Unlike the WIPO and eResolution, the NAF regularly distributed press releases heralding recent decisions. From May through August 2001, for example, I received several press releases, all but one of which promoted a complainant win.

Exhibit 21 hereto. Another NAF News Release lists "Lenders Adopting Forum Agreements," and also provides the names of twenty-one individuals who specialize in representing financial institutions and banks as "Information Resources." Exhibit 22 hereto. There are no consumer advocates, or lawyers who specialize in representing consumers, included among the persons endorsing or serving as "Information Resources" for the NAF.

One of the persons worth noting on this list of "resources" is Alan Kaplinsky, the "Partner-in-charge" of the Consumer Financial Services Group with the law firm Ballard, Spahr, Andrews & Ingersoll. Mr. Kaplinsky has a deep relationship with NAF. In addition to serving as a resource for the NAF, and speaking out repeatedly and filing amicus briefs on their behalf, Mr. Kaplinsky has advised lenders to hire NAF as its arbitration service provider. *See, e.g.,* excerpts of Deposition of Clinton Walker (formerly general counsel of First USA Bank), Exhibit 23 hereto, at 220-21. Mr. Kaplinsky is also the person who received the letter from Mr. Haydock referenced in subpart III-A of the Statement of Facts above, advising him on how his clients could best defeat a certain category of lawsuits. In addition, NAF's top executive and shareholder, Ed Anderson, has testified that he has met with Mr. Kaplinsky "maybe 20" times, or "maybe 12." Anderson Depo. in *Hubbert v. Dell*, Exhibit 16, at 86.

So why the emphasis on Mr. Kaplinsky? According to his firm's website, its "Consumer Financial Services Group has developed one of the pre-eminent and largest consumer financial services litigation defense practices in the country, defending banks and other financial institutions throughout the United States in class actions and other Am. Complex litigation." <http://www.ballardspahr.com/home.htm>. In an article entitled "Excuse me, but who's the predator: Banks can use arbitration clauses as a defense," *Bus. Law.* 24 (May/June 1998),

Kaplinsky wrote that "Consumers have been ganging up on banks. But now the institutions have found a way to defend themselves." *Id.* at 24. The article makes clear that mandatory arbitration is this "defense" for financial institutions against consumer claims, and notes that "Arbitration is a powerful deterrent to class action lawsuits. . . ." *Id.* 24-26. *See also* Kaplinsky, "Alternative to Litigation Attracting Consumer Financial Services Companies," *Consumer Financial Services L. Report* (1997) ("[i]n an attempt to eliminate the risks inherent in litigation *and discourage future lawsuits*, many consumer financial services companies have implemented arbitration programs.") (emphasis added). Consumers looking for truly neutral, independent decision makers might well ask if Mr. Kaplinsky would recommend NAF to clients such as First USA, if he did not feel that NAF would serve his twice-published objective of "defending" lenders against consumer lawsuits.

Another link between NAF and lenders comes from its principal, Edward C. Anderson. Immediately prior to becoming the head of a "neutral" organization, Mr. Anderson worked as in-house litigation counsel at ITT Financial Services. *See* Anderson Depo. in *Toppings*, Exhibit 15, at 11. At that time, ITT Financial was a lender beset with consumer lawsuits for financial wrongdoing. *See Patterson v. ITT Consumer Fin. Corp.*, 14 Cal. App.4th 1659, 18 Cal. Rptr.2d 563 (1993). In other words, when Mr. Anderson left one job on a Friday, he was charged with defending a particular lender against consumer cases against it. The following Monday, he was supposedly the head of a "neutral" firm choosing the arbitrators of cases involving that company.

As one indication of the favoritism that NAF offered to ITT Financial after Mr. Anderson left that company and became the head of NAF, this Court could look to two documents that came out of the attachments to the 1994 deposition of Mr. Anderson in *ITT Commercial Finance*

Corp. v. Wagerin. In a letter attached as Exhibit 6 to Mr. Anderson's 1994 deposition, an official of Equilaw (Equilaw was NAF's corporate parent in of 1994, *see* Anderson Depo. in *Toppings*, Exhibit 15, at 10), proposed an arbitrator for an ITT Commercial Finance Corp. case despite the fact that the arbitrator's law firm represented three other ITT corporations. In Exhibit 7 to Mr. Anderson's 1994 deposition, Equilaw official proposed an arbitrator for another ITT case, even though the arbitrator then represented the law firm that represented ITT in that case, albeit "in an unrelated case." See Exhibit 23 hereto.

As another indication of the depth of NAF's relationship with lenders, and as the previous section indicates, NAF also routinely sends letters and "information packages" to lenders that offer legal advice to lenders on the issue of how best to defeat consumers' challenges to mandatory arbitration clauses.

As another indication of NAF's closeness to lenders, it is worth noting that NAF regularly engages in ex parte contacts with defense lawyers who represent lenders, while not extending this same courtesy to consumer plaintiffs or to counsel who represent such plaintiffs. *See, e.g.,* Exhibits 24, 25, and 26 hereto (affidavits of Richard Fisher, Gregory Duhl, and Bren Pomponio).

NAF has also displayed its close ties to lenders by repeatedly entering into litigation between lenders and against consumers as an *amicus*. While NAF's briefs always state that it is officially taking neither party's side, in fact the positions and arguments that it advances in each and every one of these briefs supports the positions that the defendant lenders were taking in the litigation and opposed the positions being taken by the individual consumers. *See, e.g.*, Brief of *Amicus Curiae* National Arbitration Forum, appeal from *Mitchell v. Banc One Delaware*, 2004 WL 1362010, 70 Pa. D & C 4th 353 (Pa. Comm. Pl. Jan. 27, 2005); Brief of *Amicus Curiae*

National Arbitration Forum, *Marsh v. First USA Bank, N.A.*, No. 00-10648 (5th Cir Dec. 12, 2000), Brief of National Arbitration Forum as *Amicus Curiae*, *Green Tree Financial Corp. v. Randolph*, 531 U.S. 79 (2000); Brief of *Amicus Curiae* National Arbitration Forum, *Baron v. Best Buy Co., Inc.*, No-14028-E (11th Cir. Dec. 15, 1999). NAF also unsuccessfully petitioned the California Supreme Court to depublish a California Court of Appeals decision holding that an arbitration clause was unconscionable, in part, because of repeat-player bias on the part of NAF. *Mercuro v. Superior Court*, 116 Cal. Rptr.2d 671 (Cal. Ct. App. 2002). Plaintiffs know of no case in which the NAF filed one of its many *amicus* briefs in support of the factual or legal position taken by plaintiffs in a case.

C. Facts Relating to NAF's Handling of Consumer Claims

NAF's handling of consumer claims raises concerns in a great many areas. One overarching piece of evidence came in the sworn interrogatory answers of a credit card issuer, First USA Bank (whose business has since been bought and sold several times). According to First USA's own analysis of the results of NAF arbitrations between First USA and its consumers, out of a sample of nearly 20,000 arbitrations, NAF prevailed an astonishing 99.6% of the time. *See* Exhibit 17, hereto, as Attachment 6.[4]

Perhaps in response to this data, at the hearing on March 10, 2005 on discovery issues, counsel for Advance America offered to this Court a press release put out by a banking industry trade group prepared by the accounting firm of Ernst & Young, that praises the results that the

[4] This result is not surprising. At that time, First USA had been a major repeat client for NAF. In 1999, Clinton Walker, General Counsel of First USA, testified in a deposition that First USA had then paid at least $2 million to NAF in fees. Exhibit 27. This is a great deal of money to NAF, whose corporate parent Equilaw went bankrupt in 1994.

NAF has reached in consumer cases. As plaintiffs pointed out at the hearing, this document was prepared by consultants paid by the banking industry, and is about as credible as old Tobacco Institute "studies" purportedly showing that cigarette smoking was good for children's health.

The Ernst & Young "study" supposedly shows that consumers fare well in about 250 selected cases taken to arbitration before the NAF. Perhaps the most obvious flaw of this bankers-paid-for press release is acknowledged at page 6: it does not compare the results in NAF arbitration with the results consumers would get in court. That consumers win some share of the cases they bring with the NAF says little if consumers would have done better in court.

Another obvious flaw with the Ernst & Young "study" is that it assumes that a consumer who wins *any money at all* before the NAF has "prevailed."[5] If a consumer has lost their home due to mortgage fraud, however, and has a claim worth over $100,000 and they are awarded $1 by NAF no one (besides Ernst & Young) could fairly claim that they had "prevailed."[6]

The "study" assumes, at page 9, that consumers were satisfied in every case that they dismissed. In light of NAF's declared "loser pays" policy, as set forth in the prior section, of

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[5] NAF's own Ed Anderson himself has acknowledged that NAF's records are set up to support claims of such an unrealistic result:

> Q. For example, if that person from Granite City had a $1400 dispute with Dell and ended up getting $100 from Dell, would that be listed in your system as a victory for the consumer?
>
> A. It captures who gets the award.

Anderson Depo. in *Hubbert v. Dell*, Exhibit 16, at 37-38.

[6] When this factor is considered, the evidence shows that the monetary awards to individuals suing corporations in court are higher than those awarded in BMA. *See Armendariz v. Armendariz v. Found. Health Psychcare Services, Inc.*, 24 Cal. 4th 83, 99 Cal. Rptr. 2d 745, 6 P.3d 669 (2000) ("the amount awarded [in arbitration] is on average smaller"). As set forth above, NAF itself has stressed this fact to potential corporate clients, advertising itself as a way of "minimizing . . . the threat of lender liability jury verdicts," and as "the alternative to the million dollar lawsuit."

threatening consumers who do not prevail before the NAF with paying the banks' attorneys' fees, however, it is likely that consumers who encounter an arbitrator who is favorable to the bank and then decide to drop a case are just trying to avoid retaliation rather than expressing "satisfaction."

The Ernst & Young telephone survey results of customer satisfaction are meaningless, similarly, because the sample is so tiny. There were only 29 respondents.

The Ernst & Young "study" unintentionally dramatizes the extent to which NAF arbitration is favored by corporations and not consumers. NAF's Executive Director testified in 2004 that NAF handles 50,000 cases per year brought by corporations against individual consumers. Exhibit 28 hereto. The Ernst & Young "study" shows that consumers brought only 256 cases before NAF in a period of four *years*, however. The Bankers' Association's own press release thus establishes the extent to which the NAF is a corporate service: in a single year it handled almost 200 cases by corporations against consumers for every one case it had handled over a four year period that was brought by consumers against corporations.

Finally, the Ernst & Young press release demonstrates NAF's close relationship with lenders. Unlike its competitors such as the American Arbitration Association and JAMS, the NAF has largely refused to comply with a California statute, C.C.P. § 1281.96, that requires private arbitration companies to disclose certain information about consumer disputes that they handle.[7] This statute requires arbitration companies to publicly disclose includes the number of

[7] For example, despite handling tens of thousands of MBNA consumer cases, NAF has not posted the results of its MBNA cases on its website. And in general, NAF's most prominent posting on the subject is an assertion that it is not require to comply with this consumer protection statute (a position not taken by AAA or JAMS) because it is supposedly exempted by federal law. One California court has specifically noted that NAF has not complied with this law. See Superior Court decision in *Klussman v. Cross-Country Bank*, Exhibit 29 hereto, at 9 ("By way of dicta, the Court notes that the arbitration provision may also not be enforceable because NAF does not comply with C.C.P. 1291.96.") In any case, it is extremely

cases the arbitration firm has handled for various corporations (so consumers can tell if a given arbitration firm has an ongoing and recurring relationship with a given company), the disposition of those cases (so consumers can ascertain if a given arbitration company tends to favor a given corporation), and the total costs imposed on consumers who have had their cases handled by that arbitration firm. While NAF has posted a few cases (unlike AAA and JAMS, that have posted information on hundreds of cases), it has refused to post the results of cases where it NAF has posted a statement that it believes that this statute is preempted by federal law.

In addition to broad statistics, however, there is a wealth of other troubling facts about the way that NAF handles consumer cases. In one infamous case, for example, a state appellate court found that the NAF was requiring consumers living in California to travel to Minnesota to pursue small predatory lending claims. Accordingly, the court held that a lender's arbitration clause that required consumers to bring their claims before the NAF was unconscionable. *See Patterson v. ITT Consumer Fin. Corp.*, 14 Cal. App.4th 1659, 18 Cal. Rptr.2d 563 (1993). (NAF subsequently changed that particular rule. It can hardly win many lender clients if it persists in insisting upon such extreme rules that its clauses cannot be enforced.)

In another case, a consumer responded to a notice of arbitration by arguing that the NAF had no jurisdiction over her. The NAF directed a consumer to elaborate on her claims that it had no jurisdiction, and she did so. Then, the NAF entered an award against her in the full amount sought by the lender, *without giving her a chance to even present her argument on the merits.*

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hard for a normal person to find the few cases that NAF has posted, as one must click upon about half a dozen links, the last of which is not even highlighted.

(NAF's characteristic decision to refuse to permit this consumer to even present her argument on the merits was significant – she had already paid the full amount that the lender had agreed would satisfy her debt.) *See* Affidavits of Justin Baxter and Laurie Raymond, Exhibit30 hereto.

In another case, a consumer documented that NAF violated its own rules repeatedly to favor a corporate defendant over a consumer. The NAF accepted late filings from the defendant, engaged in ex parte communications with the defendant, required the consumer (but not the defendant) to hand write a lengthy case number on every page of documents, and refused to even accept pleadings relating to certain procedural issues from the consumer. This well educated consumer concluded that "it was impossible for me to get a fair result through arbitration before the NAF." Affidavit of Gregory Duhl, Exhibit 25 hereto.

In another case, a consumer was given an option of refusing arbitration when a credit card company adopted its arbitration clause, and she did so. Later, the credit card company nonetheless brought a claim against her with NAF. She sent an affidavit to NAF proving that she had never agreed to arbitration, and received no response. Later, she learned from a debt collector (having heard nothing from the NAF itself) that NAF had issued an award against her for the full amount claimed by the lender. Affidavit of Eve Curtis, Exhibit 31 hereto.

Another consumer who opted out of an arbitration agreement through certified mail (as that agreement supposedly permitted), and who fully documented that fact to the NAF, received the same pro forma result: a judgment for the lender for everything it wanted, in a case where NAF had no jurisdiction at all, with no explanation:

> 10. On or about August 1, 2005, I received a notice from NAF indicating that it was going forward with the arbitration in Minnesota. A copy of this notice is attached hereto as Exhibit F. NAF has not responded to my letter of July 23, 2005 or the

fact that Mr. Marchand and MBNA agreed that the arbitration provision was not effective as to Mr. Marchand and the fact that Mr. Marchand has objected to arbitration of his rights under his agreement with MBNA.

Affidavit of Lester A. Perry, Exhibit 32 hereto.

Roughly the same story was told by another identity theft victim, in whose name someone else had opened a credit card account:

5. In late 2002 and early 2003, I received three notices of Arbitration from the NAF. In each case, I responded by sending a letter explaining that the accounts were not mine, that I had never agreed to any arbitration provision, and that the credit card company had never provided the requested debt verification. True and correct copies of my letters are attached as Exhibits A, B, and C.

6. The NAF never required the credit card company to prove that I was responsible for the debt or that I was bound by an arbitration agreement. Despite the fact that I was not responsible for the debt and was never a party to an arbitration agreement, and that I informed the NAF of these facts, the NAF entered three arbitration awards against me.

Affidavit of Patricia Meisse, Exhibit 33 hereto.

Similarly, another consumer who was the victim of an identity theft got the same short shrift from the NAF. In this case, a consumer not only documented that he had never opened a credit card with a lender (much less agreed to arbitration of claims with that lender), but the bank acknowledged in writing that it had made an error about the account number involved. Nonetheless, the NAF produced its usual result:

8. On November 24, 2004, despite the fact that MBNA's own evidence established conclusively that the account submitted to NAF arbitration was not my client's account, the NAF entered an award for MBNA on the original claim.

Affidavit of Joanne Faulkner, Exhibit 34 hereto.

NAF's pro-lender handling of consumer claims is also evidenced by a practice that it widely promotes to lenders as being more favorable to them than the rules of its competitors,

such as the non-profit American Arbitration Association: NAF's rules limit awards to "the amount of the claim." *See* NAF Code of Procedure, Rule 37.B. This practice prohibits the recovery of damages based on new evidence discovered during the litigation. The nature of lending litigation, however, is that the full extent of a lender's wrongdoing (and thus the damages that would be appropriate to award the plaintiff) often cannot be known until the plaintiff has had an opportunity to pursue reasonable discovery. Am. Complex fraud schemes, for example, can generally only be identified after layers of deceit and obfuscation are peeled away and the true facts are made known. NAF's rule capping awards is particularly pernicious, because NAF's rules pressure consumers to reduce the amount of their claim at the outset of a case. By forcing claimants to place a dollar figure on their claim, not only must a consumer sacrifice her or his right to access the courts, the consumer also waives relief he or she would be entitled to under the law.

In a similar vein, NAF boasts to lenders that its rules provide for "[v]ery little, if any, discovery." Exhibit 17, attachment 7. The consequence of this rule for consumers is obvious. Consumers have the burden or proof, but few borrowers with valid legal claims have independent access to a lender's documents. As NAF knows well, all pertinent paper and loan documents are typically held by the lender. By denying the consumer access to discovery, NAF rules effectively prohibit consumers from proving their case. In *Armendariz v. Foundation Health Psychare Services, Inc.*, 24 Cal. 4th 83, 104 (2002), for example, the California Supreme Court held that "adequate discovery is indispensable for the vindication of FEHA claims."

Another indication of NAF's approach to consumers is found in the fact that several courts have refused to enforce NAF arbitration clauses on the grounds that NAF often imposes

unreasonable fees on consumers who wish to bring claims. While Check N Go here offers to pay most of plaintiffs' arbitration fees, NAF's practice of imposing large (and largely hidden) costs on consumers where possible says much about its approach to consumer claims. *See, e.g., Eagle v. Fred Martin Motor Co.*, 809 N.E.2d 1161, 1177 (Ohio Ct. App. 2004) ("Practically speaking, such arbitration costs would serve to deter even low-income persons who do not qualify for indigent status, as well. That a consumer such as Ms. Eagle, a primary caregiver for one child and who recently made approximately $20,000 per year, would be willing and able to expend on a conservative scale between $4,000 and $6,000 on arbitration fees and costs, is highly doubtful."); *Licitra v. Gateway, Inc.,* 189 Misc. 2d 721, 734 N.Y.S.2d 389 (N.Y. Civ. Ct. 2001) ("outlining the NAF's fees and concluding that "[i]t is obvious that these costs can make arbitration not a viable alternative for many consumers."); *Ferguson v. Countrywide Credit Indus., Inc.*, 298 F.3d 778 (9th Cir. 2002) (arbitration clause was unconscionable, in part, because of NAF's fees); *Tamayo v. Brainstorm USA*, Case No. 01-20386 JF (N.D. Cal. March 29, 2002), on appeal, No. 02-51721 (arbitration clause unconscionable, in part, because NAF's fees were prohibitive).

D. Facts Relating to NAF's Power to Influence the Outcomes of Arbitrations

In a number of other cases where consumer plaintiffs have challenged the NAF, lender defendants have made some variant of this argument: "it doesn't matter whether the people who run the NAF are biased in favor of lenders and against consumers, or have financial incentives to favor lenders, because the only thing that matters is the arbitrators themselves. Unless the plaintiffs can prove that each of the arbitrators themselves is biased, the court must reject the challenge." A few courts have even accepted this argument.

In fact, NAF wields enormous power in these cases. The mechanics of selecting an arbitrator involve a system of strikes that inevitably results in an arbitrator who ultimately is selected solely by the NAF Director. "The parties are provided with a list of names that is one more than the number of parties." *See* Dep. of Anderson in *Toppings*, Exhibit 15 hereto, at 78. Each party then gets to make one strike. In cases such as this, the plaintiffs would strike one arbitrator from the list and the lender defendant would strike one. Left after the strikes would be the one extra arbitrator selected by the NAF. If NAF were to submit a list of arbitrators in which two had strong ties to corporate lenders, one of those two would almost certainly end up as the decision maker replacing the courts and the jury system for the case.

This fact is nailed down by the sworn testimony of Michael Geist, a law professor who studied every single decision entered in an Internet domain name dispute between the program's inception in 1999 and February of 2002 (4,332 cases), where the more powerful party and the party selecting the arbitrator is the Am. Complainant (unlike lending disputes, where that party is typically the defendant):

> 7. . . . I concluded that the NAF disproportionately assigned arbitrators who issued pro-Am. Complainant rulings, and thus exerted influence over the outcomes of arbitrations in the UDRP system in order to market itself favorably to Am. Complainants, who have the exclusive power to choose whether the NAF or a different provider will earn their business.
>
> ...
>
> 12. Fourth, the study found that case allocation by the NAF appeared to be heavily biased toward ensuring that a majority of cases were steered toward Am. Complainant-friendly panels. Most troubling was data that suggested that, despite claims of impartial random case allocation as well as a large panel of panelists, the majority of NAF single panel cases were actually assigned to little more than a handful of panelists. Of the 1,379 NAF cases decided by a single NAF-assigned arbitrator through February 18, 2002, 778 of them – 56.4% – were decided by

only six arbitrators. (In comparison, the six busiest single panelists at the two other providers accounted for approximately 17% of those providers' single panel caseloads.

...

15. By assigning the majority of cases to the subset of arbitrators who ruled most consistently for its clients, the Am. Complainants, the NAF exerted a great deal of influence over case outcome. When combined with the fact that outcome was the most decisive factor among Am. Complainants choosing arbitration providers, and evidence that the NAF aggressively marketed its services to potential claimants by promoting Am. Complainant wins, this data supports the conclusion that the NAF used its control over the selection of arbitrators in single panel cases to achieve outcomes that would enable it to attract the business of future UDRP Am. Complainants.

Geist Affidavit, Ex. 20 hereto.

In addition to the power to select the arbitrator, the NAF rules extend all sorts of other crucial powers to NAF's director and staff, refuting the claim that it does not matter whether the NAF is structured in an inherently biased manner. The Rules give the Director the ability to grant extensions (Rule 9.D), hear motions (Rule18), alter fees for intervention and hearings (Rule 19.B, 19.D), set the length of hearings (Rule 26), issue orders, including at his own initiative (Rule 38), request involuntary dismissal of a claim (Rule 41), waive fees (Rule 45), request sanctions (Rule 46), interpret the code (Rule 48.A), and change the code (Rule 48.F). See Rules of the National Arbitration Forum attached hereto as Exhibit 35.

E. Facts Relating to NAF's Propensity Towards Dishonesty

NAF and its principles have shown a disturbing propensity to say things that are simply untrue, where they think that doing so will induce a court to enforce an arbitration clause. Perhaps the best known example came from the case of *Toppings v. Meritech Mortgage Services, Inc.*, 569 S.E.2d 149 (W. Va. 2002), where the West Virginia Supreme Court of Appeals struck

down a lender's arbitration clause as unconscionable. As will be discussed below, there, as here, the lender required its consumers to take all claims to the NAF, and the *Toppings* court held that this created impermissible structural incentives to bias.

When the plaintiffs first challenged the NAF as being biased in the *Toppings* case, NAF rushed to provide the defendant lenders with the names of well-regarded members of the State Bar, including a respected former Justice of the Supreme Court of Appeals of West Virginia, a Professor from West Virginia University College of Law, and well respected local attorneys it claimed would be arbitrators for arbitration proceedings in West Virginia. The problem is, NAF's representations were Am. Completely false: not one of the arbitrators listed who was contacted had agreed to serve as an arbitrator for NAF at that time. *See* Affidavit of Bren Pomponio, Exhibit 26 hereto, at ¶ 6 ("Each of the people whom our office contacted replied that they had never agreed to work for the NAF as an arbitrator. At our request, some of these individuals subsequently wrote letters to the court and/or the NAF stating that they were not NAF arbitrators and that they objected to the NAF's false statement to the contrary.") *See also* Affidavit of Charles Disalvo, Exhibit 36 hereto. NAF evidently attempted to bolster the defendant lenders' argument that NAF was a neutral forum, and arbitration ought to be compelled by falsely including the names of respected attorneys from West Virginia.

NAF is also prone to attempting to deceive the general public. *See* Affidavit of Sally Greenberg, Senior Product Safety Counsel of Consumers Union, Exhibit 37 hereto at ¶ 6 ("I believe then, and continue to believe today, that the NAF solicitation letter badly misrepresented Consumers Union's position on mandatory arbitration."); and at ¶ 8 ("the NAF letter distorts the content of an article in Consumer Reports and misquotes and distorts the content of a book

published by Consumers Union. Indeed, no honest reader of either Consumers Union publication could have drawn from them the conclusion claimed by NAF.")

Similarly, in a deposition in the *Toppings* case, NAF's principal Ed Anderson flatly testified that NAF had never promised to improve the "bottom lines" of its corporate clients. See Exhibit 15 at 69. This statement was untrue. See also letter from Curtis Brown to Robert S. Banks, Jan. 14, 1999, Exhibit 18 hereto. It is understandable that Mr. Anderson would wish to deny some of NAF's most inappropriate statements, but it is troubling that he would falsely do so in a deposition.

Also along these lines, Mr. Anderson has testified under oath that NAF had not represented to lenders that it would reduce their collection costs. See Exhibit 15 at 69. The truth, again, is quite different. See Exhibit 17, Attachment 8 (full page NAF advertisement asserting that "Arbitration can save up to 66% of your collection costs.")

The plaintiffs and the other parties to this litigation have a right to a neutral decision maker, not one who will say anything, regardless of the truth, to a court in order to ensure arbitration occurs and its financial interests are protected.

ARGUMENT

I. CHECK 'N GO'S MANDATORY INDIVIDUAL ARBITRATION CLAUSE VIOLATES NORTH CAROLINA PUBLIC POLICY AGAINST EXCULPATORY CLAUSES AND IS UNCONSCIONABLE

Despite the existence of federal and state policy favoring arbitration as a means of resolving disputes, "this public policy does not come into play unless a court first finds that the parties entered into an enforceable agreement to arbitrate." *Sears Roebuck and Co. v. Avery*, 163

N.C. App. 207, 211m 593 S.E.2d 424, 428 (2002). Accordingly, "before a dispute can be settled in this manner, there must first exist a valid agreement to arbitrate." *King v. Owen*, 166 N.C. App. at 248, 601 S.E.2d at 327. "The law of contracts governs the issue of whether there exists an agreement to arbitrate." *Id.* (quoting *Routh v. Snap-On Tools Corp.*, 108 N.C. App. 268, 271, 423 S.E.2d 791, 794 (1992)). Here, Check 'N Go cannot satisfy this threshold requirement because its mandatory individual arbitration clause violates North Carolina contract law prohibiting adhesive, exculpatory clauses in contracts affecting public interests, and is also procedurally and substantively unconscionable.

A. Check 'N Go's Arbitration Clause is Governed by North Carolina Law.

As a threshold matter, Check 'N Go's footnoted assertion, Brief at 13 n.6, that Delaware (not North Carolina) law governs this arbitration clause because of its choice-of-law provision should be rejected. Under North Carolina's choice-of-law rules, a contractual choice of law clause cannot be enforced if *either* of the following conditions is met:

> (a) the chosen state has no substantial relationship to the parties or the transaction and there is no other reasonable basis for the parties' choice, or
>
> (b) application of the law of the chosen state would be contrary to a fundamental policy of a state which has a materially greater interest than the chosen state in the determination of the particular issue and which . . .would be the state of applicable law in the absence of an effective choice of law by the parties.

Cable Tel Services, Inc. v. Overland Contracting, Inc., 154 N.C. App. 639, 643, 574 S.E.2d 31, 33-34 (2002). Here, both of these conditions barring enforcement of a choice-of-law clause are present.

First, this case is between North Carolina consumers and North Carolina lenders over payday loan transactions that all took place within North Carolina. Therefore, this dispute between these North Carolina parties over these loans made in North Carolina can only reasonably be governed by North Carolina law. *See Bundy v. Commercial Credit Co.*, 200 N.C. 511, 516, 157 S.E. 860, 863 (1931) (finding parties' Delaware choice of law clause "immaterial" based on trial record that "[did] not disclose that any transaction took place in Delaware or that the parties even contemplated either the making or the performance of the contract in said State.")

Second, Plaintiffs' challenges to Check 'N Go's arbitration clause allege that the clause is an illegal exculpatory clause that violates North Carolina public policy, that it is unconscionable, and that it is unenforceable because the entire payday loan contract is illegal and void under numerous North Carolina consumer protection statutes. *See*, *infra* at §§IB and C and III. To the extent Check 'N Go argues that Delaware law compels a contrary result on *all* of these questions, this result would violate the fundamental policies of North Carolina discussed herein. Therefore, the Delaware choice-of-law clause is invalid, and the case should be governed by the law of North Carolina, where all of the underlying payday loan transactions occurred and where all of the named parties reside.

B. The Mandatory Individual Arbitration Clause is an Illegal Exculpatory Clause.

It is well-established law in North Carolina that "[c]ontracts which seek to exculpate one of the parties from liability for his own negligence are not favored by the law." *Hill v. Carolina Freight Carriers Corp.*, 235 N.C. 705, 71 S.E. 2d 133 (1952) (citation omitted). While

exculpatory contracts are not prohibited *per se*, such a contract will not be enforced if "it violates a statute, is gained through inequality of bargaining power, or is contrary to a substantial public interest." *Fortson v. McClellan*, 131 N.C. App. 635, 636, 508 S.E.2d 549, 550 (1998) (quoting *Jordan v. Eastern Transit & Storage Co.*, 266 N.C. 156, 146 S.E.2d 43 (1966)).[8] Furthermore, the North Carolina Constitution provides that "every person for an injury done him in his lands, goods, person, or reputation shall have remedy by due course of law; and right and justice shall be administered without favor, denial, or delay. N.C. Const., Art. I, 18.[9]

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[8] *See also Tatham v. Hoke*, 469 F. Supp. 914, 917 (M.D.N.C. 1979) (liability-limiting contracts are "void as contrary to public policy . . . when they relate to transactions affected with a substantial public interest or colored by inequality of bargaining power."); *Hall v. Sinclair Refining Co., Inc.*, 242 N.C. 707, 710, 89 S.E.2d 396, 398 (1955) ("[C]losely related to the public policy test of determining the validity of these exemption clauses is the factor . . . of giving consideration to the comparable positions which the contracting parties occupy in regard to their bargaining strength."); *Miller's Mutual Fire Ins. Ass'n of Alton, Ill. v. Parker*, 234 N.C. 20, 22, 65 S.E.2d 341, 342 (1951) ("A provision in a contact seeking to relieve a party to the contract from liability for his own negligence may or may not be enforceable. It depends upon the nature and the subject matter of the contract, the relation of the parties, the presence or absence of equality of bargaining power and the attendant circumstances."); *cf. Fortson*, 131 N.C. App. at 638 (distinguishing case upholding liability waiver on grounds that earlier court "did not characterize the release as an adhesion contract involving unequal bargaining power and did not hold that such contracts involved a public interest.") (citation omitted).

[9] See also, N.C. Const., Art. I, 35 ("A frequent recurrence to fundamental principles is absolutely necessary to preserve the blessings of liberty.")

Therefore, under North Carolina's public policy rule against enforcing adhesive, exculpatory contracts, the validity of Check 'N Go's mandatory individual arbitration clause turns on two factors: (1) whether it is *either* (a) an adhesion contract that is the result of unequal bargaining power between the company and its payday loan-borrowing customers, *or* (b) part of a contract whose subject matter is regulated therefore deemed to affect public interests; *and* (2) whether the arbitration clause's terms are exculpatory. As is demonstrated below, *all* of these conditions are easily established here. The arbitration clause therefore is contrary to public policy and unenforceable.

1. The Clause Resulted from Severely Unequal Bargaining Power.

It is clear beyond serious dispute that Check 'N Go's mandatory individual arbitration clauses here are products of extreme inequalities in bargaining power and commercial sophistication between the company and plaintiffs. As set forth in the statement of facts, Check 'N Go is a large, multi-state lending company, with over 1,000 store locations in 29 states, with annual revenues in excess of $12 million. *Supra* at § IIA. Plaintiffs, by contrast, are financially pressed consumers who were forced by their limited credit options into seeking out these high-interest payday loans to meet their basic living expenses. *Id.* It is hard to imagine a situation involving a greater disparity of bargaining power unless Microsoft Corporation begins to contract with homeless people.

In contrast to Check 'N Go's superior bargaining position, the Plaintiffs' lack of bargaining power is apparent. First, plaintiffs lacked any meaningful choice to obtain a loan without agreeing to arbitration, as almost every payday lender with an office in North Carolina requires prospective borrowers to sign arbitration clauses specifically prohibiting class actions.

Supra, at § IIC . Second, the arbitration clauses imposed by Check 'N Go, like the other provisions in these payday loan contracts, were non-negotiable adhesive provisions. Plaintiffs were given no opportunity to negotiate over these arbitration clauses, but instead were hurried into signing them without any explanation given, while other customers were waiting behind them. *Supra* at § IIB. Third, even if plaintiffs could have negotiated with Check 'N Go, it would have been a hollow exercise because plaintiffs would not have known what it was they were negotiating. As Beth Weir explains in her affidavit, Check 'N Go's arbitration clause was so Am. Complex that few if any payday loan customers could have understood it. *Supra*, at § IID. Therefore, Plaintiffs and the putative class members could not have obtained these loans anywhere in North Carolina without first agreeing to exempt their lender from class-wide liability.

Under North Carolina law, adhesive contract provisions resulting from unequal bargaining power are closely scrutinized, and will not be enforced if they relieve the stronger party from liability. *Fortson*, 131 N.C. App. at 637, 508 S.E.2d at 551, ("[A]n exculpatory contract will be enforced unless it . . . is gained through inequality of bargaining power."). This requirement for close scrutiny applies as well to adhesive arbitration clauses. *See Sciolino v. TD Waterhouse Investor Serv's, Inc.*, 149 N.C. App. 642, 645, 562 S.E.2d 64, 66 (2002) ("This apparent requirement for independent negotiation underscores the importance of an arbitration provision and militates against its inclusion in contracts of adhesion.") (citations omitted). Thus, North Carolina courts have struck down as against public policy exculpatory clauses in adhesive consumer contracts that resulted from disparities in bargaining power. *See, e.g., Gore v. Ball*, 279 N.C. 192, 202-03, 182 S.E.2d 389, 395 (1971) (striking warranty waiver in seed

manufacturer's sale to farmers, noting that "[i]f such practice is sufficiently widespread among seed vendors and is sufficient to limit the vendor's liability, the farmer will find it virtually impossible to purchase seed with an effective right of recourse . . ."); *Jordan v. Eastern Transit & Storage Co.*, 266 N.C. 156, 163, 146 S.E.2d 43, 49-50 (1966) (striking liability limiting clause in warehouse storage contract).

Check 'N Go does not (and cannot) seriously dispute the record evidence showing that as a major provider of payday loans in a market where arbitration clauses are universal, it could impose these adhesive, non-negotiable, and incomprehensible arbitration clauses without having to worry about any opposition from its financially-strapped customers. Therefore, the Court should find that these clauses are the product of a severe inequality in bargaining power.

2. Check 'N Go's Payday Loans are Heavily Regulated and Affect Important Public Interests.

North Carolina's general prohibition against exculpatory clauses in adhesive contracts has been applied most frequently to contracts imposed by defendants in regulated industries. For example, in *Tatham v. Hoke*, 469 F. Supp. 914 (W.D.N.C. 1979), the district court, applying state law, invalidated a liability cap in a doctor-patient contract as contrary to public policy, finding in relevant part that "the contract is a contract for exculpation from liability of an enterprise that is heavily regulated by state authorities who have demonstrated the public interest in the activity and stated a desire to leave the regulated entities amendable to private suit as well as public review." *Id.* at 919.[10] *Tatham* held that, while "a clear and significant inequality of bargaining

[10] *See also Gore v. Ball*, 279 N.C. at 202-03, 182 S.E.2d at 294-396 (striking liability limitation in seed manufacturer's contract with farmers); *Jordan v. Eastern Transit*, 266 N.C. at 162-63, 146 S.E.2d at 48-49 (treating warehouse storage contract as subject to regulation of common carriers); *Fortson*, 131 N.C. App. at 638, 508 S.E.2d at 551 (motorcycle training course found to implicate public safety interests).

power must be demonstrated to support invalidation of a limitation of liability clause in the private sector, . . . a much lesser showing, if any, is required when the entity seeking exculpation is heavily infected with a public interest." *Id.* (citations omitted).

Similarly, in the present case, North Carolina has a "powerful public interest" in protecting North Carolina citizens against actors who violate the Consumer Finance Act. *See New Bern Pool & Supply Co. v. Graubart*, 94 N.C. App. 619, 625, 381 S.E.2d 156, 160 (1989) ("The interest of the State of North Carolina in providing consumer protection for its citizens and corporate entities and a forum for the adjudication of controversies involving them is substantial.")

Here, it is also beyond serious dispute that the payday lending industry is heavily regulated in North Carolina by various laws – such as the Consumer Finance Act, the Deceptive Trade Practices Act, the Check Casher Act, and state usury provisions – that are designed to protect consumers and the public from unscrupulous financial practices. The North Carolina General Assembly has attempted to regulate this industry for more than 80 years. This fact of heavy industry regulation is particularly true in North Carolina, where payday lending has been made illegal on at least two separate occasions and where one of Check 'N Go's biggest rivals, Advance America, has been the subject of State regulatory investigations concerning the legality of its operations. *Supra* at § IIG.

Since the record evidence plainly demonstrates *both* that there was severe inequality in bargaining power between Plaintiffs and Check 'N Go *and* that payday lending is heavily regulated out of a public concern for protecting consumers (though only one of the above need be shown), any provision in these payday loan contracts found to be exculpatory is contrary to

public policy and cannot be enforced.

3. The Arbitration Clause's Class Action Ban is Effectively Exculpatory.

North Carolina's prohibition on exculpatory clauses in adhesive contracts that affect the public interest applies not only to clauses that explicitly strip parties of legal remedies, but also to terms that effectively strip them of these remedies by making it prohibitively burdensome to vindicate their claims.

As the Statement of Facts demonstrates, *supra* at § IIE, Check 'N Go's mandatory individual arbitration clause acts as an exculpatory clause for the types of claims Plaintiffs have here by prohibiting them from bringing these claims on a class-wide basis. Simply put, the Plaintiffs' claims are individually too small to be viable unless they can be aggregated into a class action. A host of fact and expert witnesses, including 18 private consumer lawyers and four North Carolina legal services lawyers who represent consumers, all testified that Check 'N Go's contractual ban on class actions will, if enforced, shield the company from liability to virtually all of its borrowers *without regard to the validity of these consumers' claims.*

Moreover, as an empirical matter, the exculpatory effect of Check 'N Go's class action ban is irrefutable. No Advance America customer has initiated an individual claim in arbitration against the company in the last eight years. *See supra* at § IIE. If the class action ban had no effect on a borrower's substantive rights, one would expect that Check 'N Go would face at least *some* individual arbitrations over eight years. The fact is, however, that these claims simply are not brought on an individual basis.

This unrebutted record evidence is consistent with decades of findings by the U.S. Supreme Court and other courts on the necessity of class actions for vindicating small-value

consumer claims. In *Eisen v. Carlisle & Jacqueline*, 417 U.S. 156 (1974), the Supreme Court reversed a denial of class certification in an antitrust case based in part on its finding that:

> A critical fact in this litigation is that petitioner's individual stake in the damages award is only $70. No competent attorney would undertake this Am. Complex antitrust action to recover so inconsequential an amount. Economic reality dictates that petitioner's suite proceed as a class action or not at all.

Id. at 161. More recently, the Supreme Court reiterated in addressing standards for class action settlements that "[t]he 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." *Amchem Products, Inc. v. Windsor*, 521 U.S. 591, 617 (1997).[11]

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[11] *See also Deposit Guaranty Nat'l Bank v. Roper*, 445 U.S. 326, 338 n.9 (1980) ("Here, the damages claimed by the two named plaintiffs totaled $1,006.00. Such plaintiffs would be unlikely to obtain legal redress at an acceptable cost, unless counsel were motivated by the fee-spreading incentive and proceed on a contingent-fee basis. This, of course, is a central concept of Rule 23."); *Weiss v. Regal Collections*, 385 F.3d 337, 345 (3d Cir. 2004) ("Representative actions appear to be fundamental to the statutory structure of the [Fair Debt Collection Practices Act]," so that "lacking this procedural mechanism, meritorious FDCPA claims might go unredressed because the awards in an individual case might be too small to

prosecute an individual action."); *Linder v. Thrifty Oil Co.*, 2 P.3d 27, 30-31 (Cal. 2000) ("Courts have long acknowledged the importance of class actions as a means to prevent a failure of justice in our judicial system."); *Riley v. New Rapids Carpet Center*, 294 A.2d 7, 10 (N.J. 1972) ("If each victim were remitted to an individual suit, the remedy could be illusory, for the individual loss may be too small to warrant a suit or the victim too disadvantaged to seek relief. Thus the wrongs would go without redress, and there would be no deterrence to further aggressions. If there is to be relief, a class action should lie unless it is clearly infeasible."); *Friar v. Vanguard Holding Corp.*, 434 N.Y.S.2d 698, 706 (App. Div. 1980) ("By construing the availability of class action relief narrowly, the judiciary is seen as denying access to the courts to thousands of individuals whose minimal damages are greatly outweighed by the prohibitive costs involved in prosecuting a lawsuit against a wealthy opponent."); *Cruz v. All Saints Healthcare Sys., Inc.*, 625 N.W.2d 344, 348-49 (Wis. App. 2001) ("[G]iven the economic realities of this case, class action may be the only effective means to implement the legislature's intent to provide redress for unreasonable charges . . . The individual amounts at issue are small and not likely to justify individual suits.")

These conclusions also are consistent with those reached by courts across the country in holding that provisions in consumer contracts banning class actions are exculpatory and therefore against public policy or unconscionable. In *Szetela v. Discover Bank*, 118 Cal. Rptr. 2d 862 (Cal. App. 2002), the court cogently set out the argument for why a provision banning class actions turns an ordinary arbitration clause into an exculpatory one, effectively acting as a "get out of jail free" card for corporate defendants:

> It is the manner of arbitration, specifically, prohibiting class or representative actions, we take exception to here. The clause is not only harsh and unfair to Discover customers who might be owed a relatively small sum of money, but it also serves as a disincentive for Discover to avoid the type of conduct that might lead to class action litigation in the first place. By imposing this clause on its customers, Discover has essentially granted itself a license to push the boundaries of good business practices to their furthest limits, fully aware that relatively few, if any, customers will seek legal remedies, and that any remedies obtained will only pertain to that single customer without collateral estoppel effect. . . . Therefore, the provisions violates fundamental notions of fairness.

Szetela, 96 Cal. App.4th at 1101, 118 Cal.Rptr.2d at 868.

Perhaps the leading case supporting this finding that a class action ban in a consumer contract covering small-money transactions is exculpatory is *Ting v. AT&T*, 182 F. Supp. 2d 902 (N.D. Cal. 2002), *aff'd in relevant part and reversed in part on other grounds*, 319 F.3d 1126 (9th Cir. 2003). In *Ting*, the federal district court conducted a trial over several questions concerning whether several provisions, including a class action ban, in the phone company's mandatory arbitration clause were unconscionable. Based upon extensive proof and testimony at trial, the district court found that the ban on class actions would operate as an exculpatory clause. This evidence showed that before AT&T adopted its arbitration clause, consumers had successfully prosecuted several class actions against long distance phone carriers, including one

where AT&T paid 100% of the class's damages and another where a rival carrier paid $88 million to consumers. *Id.* at 915. AT&T stipulated to the fact that none of the plaintiffs in those earlier cases could have brought them individually, whether in court or in arbitration. *Id.* Based on these and other facts in the record, the district court held that without the class action mechanism, "the potential reward would be insufficient to motivate private counsel to assume the risks of prosecuting the case just for an individual on a contingency fee basis." *Id.* Because of these economic realities, "the prohibition on class action litigation functions as an effective deterrent to litigating many types of claims involving rates, services or billing practices and, ultimately, . . . [serves] to shield AT&T from liability even in cases where it has violated the law." *Id.* Accordingly, the court found the ban on class actions unconscionable, *id.* at 931, and the U.S. Court of Appeals for the Ninth Circuit affirmed this holding.

A host of other federal and state courts have likewise held – all in cases where the factual record did not approach the record in this case – that consumer contracts that ban class actions amount to exculpatory clauses, and therefore are not enforceable.[12]

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[12] *See, e.g., Luna v. Household Fin. Corp. III*, 236 F. Supp. 2d 1166, 1178-79 (W.D. Wash. 2002) ("The

Arbitration Rider's prohibition of class actions would prevent borrowers from effectively vindicating their rights for certain categories of claims."); *Kinkel v. Cingular Wireless, LLC*, 828 N.E.2d 812, 820-21 (Ill. App. 2005) ("[T]he ban on class-wide arbitration in a different version of Cingular's clause is substantively unconscionable because it effectively precludes consumers with small claims from seeking remedies."); *Whitney v. Alltell Communications, Inc.*, ___S.W.3d___, 2005 WL 1544777 at *5 (Mo. Ct. App. July 5, 2005) ("Here, plaintiff filed a putative class action challenging a charge of 88 cents per month. By itself, such a claim would not be economically feasible to prosecute. However, when all of the customers are added together, large sums of money are at stake. Prohibiting class treatment of these claims would leave consumers with relatively small claims without a practical remedy . . ."); *West Virginia ex rel. Dunlap v. Berger*, 567 S.E.2d 265, 278 (W.Va. 2002) ("In many cases, the availability of class action relief is a sine qua non to permit the adequate vindication of consumer rights."); *Discover Bank v. Superior Court*, 30 Cal. Rptr. 3d 76 (Cal. 2005); *Leonard v. Terminix Int'l Co.*, 854 So. 2d 529, 537 (Ala. 2002); *Eagle v. Fred Martin Motor Co.*, 809 N.E.2d 1161, 1183 (Ohio Ct. App. 2004); *In re Knepp*, 229 B.R. 821, 827 (N.D. Ala. 1999).

As the *Ting* district court found, it is clear that the availability or imposition of arbitration for small consumer claims does not ameliorate the consumers' need for the class device. Often, the same consumer claims that prove too expensive to *litigate* individually are also too expensive to *arbitrate* individually. *See* Jean R. Sternlight, *As Mandatory Binding Arbitration Meets the Class Action, Will the Class Action Survive*?, 42 WM. & MARY L. REV. 1, 90 n. 353 (2000) ("[W]here a class action is excluded from arbitration, it is likely that many if not most of the claimants will not be able to arbitrate their claims.").

The conclusions of plaintiffs' witnesses here, and the decisions cited above, are consistent with what corporate defense counsel regularly proclaim outside of court. As one defense lawyer admits, "the franchisor with an arbitration clause should be able to require each franchisee in the potential class to pursue individual claims in a separate arbitration. *Since many (and perhaps most) of the putative class members may never do that*, and because arbitrators typically do not issue runaway awards, *strict enforcement of an arbitration clause should enable the franchisor to dramatically reduce its aggregate exposure*." Edward Wood Dunham, *The Arbitration Clause as a Class Action Shield*, 16 FRANCHISE L.J. 141, 141 (1997) (emphasis added). Another defense lawyer has described arbitration clauses as a "defense" for banks against consumer claims, in part because they can be a "deterrent" to class actions. Alan Kaplinsky, *Excuse Me, But Who's the Predator: Banks Can Use Arbitration Clauses as a Defense*, BUS. LAW. 24, 26 (May/June 1998). *See also* Sternlight, *supra*, at 5 n. 2 ("Several commentators have urged companies in various industries to adopt mandatory binding arbitration, at least in part to avoid class actions.") (citing Dunham article and four others).[13]

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[13] Check 'N Go argues, without reference to *any* record evidence, that the arbitration clause's class action

Therefore, the overwhelming record evidence in this case and a considerable body of judicial and secondary authority establishes the following: (1) that Check 'N Go's mandatory individual arbitration clause is the product of extreme inequality in bargaining power between this payday lending giant and its financially-pressed borrowers; (2) that payday lending is a heavily regulated industry because of the significant public interest in protecting consumers; and (3) that the arbitration clause's explicit ban on class actions makes this an exculpatory clause that will effectively prevent Plaintiffs and other borrowers from vindicating their legal claims against Check 'N Go. For all of these reasons, the Court should hold that this mandatory individual arbitration clause is an illegal exculpatory clause that is contrary to public policy under North Carolina contract law.

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ban is not exculpatory because awards of attorneys' fees are available to Plaintiffs under North Carolina's consumer protection statutes, and because other courts have upheld class action bans. **Brief at 11, 16-17**. With no supporting evidence showing that Plaintiffs' claims *in this case* would actually be brought, however, this is no answer to Plaintiffs' more than 20 affidavits from consumer lawyers saying they would *not* bring the Plaintiffs' claims here on an individual basis *despite the availability of fee-shifting awards. Supra* at 10; *cf. Discover Bank v. Superior Court*, 30 Cal. Rptr. 3d at 87 ("There is no indication other than these courts' unsupported assertions that, in the case of small individual recovery, attorney fees are an adequate substitute for the class action or arbitration mechanism. Nor do we agree with the concurring and dissenting opinion that small claims litigation, government prosecution, or informal resolution are adequate substitutes.") Nor is this an answer to the record evidence in this case showing that no consumer has ever brought an individual case against Check 'N Go to arbitration in the eight years its mandatory individual arbitration clause has been in effect.

C. The Mandatory Individual Arbitration Clause is Unconscionable.

For many of the same reasons that Check 'N Go's arbitration clause violates public policy, it also is unconscionable. Under North Carolina contract law, "to find unconscionability there must be an absence of meaningful choice on part of one of the parties [procedural unconscionability] *together with* contract terms unreasonably favorable to the other [substantive unconscionability]." *State Farm Mutual Automobile Ins. Co. v. Atlantic Indemnity Co.*, 122 N.C. App. 67, 73, 468 S.E.2d 570, 573 (1996) (citations omitted) (emphasis in original). Here, there is abundant record evidence and case authority supporting findings of both procedural and substantive unconscionability.

As set forth in the statement of facts, the record in this case shows at least four different ways in which plaintiffs lacked meaningful choice over the arbitration clause: (1) there was an extreme imbalance in bargaining power and commercial sophistication between this payday lending giant and these financially-pressed consumers, *supra* at 6-7; (2) these arbitration clauses were non-negotiable adhesive provisions that were never explained to them and that they were hurried to sign, *id.* at 7-8; (3) every payday lender in North Carolina also requires borrowers sign arbitration clauses waiving class action rights and requiring arbitration only on an individual basis, *id.* at 8; and (4) the arbitration clause, as explained by readability expert Beth Weir, was drafted in such a Am. Complex and incomprehensible way that few if any payday customers could have understood the meaning of its terms, *id.* at 8-9. Check 'N Go offers no evidence to the contrary.

Taken together, this evidence shows conclusively that Plaintiffs and the putative class of payday loan borrowers had no meaningful choice over these arbitration clause terms because they

did not and could not understand their effect, they could not negotiate with Check 'N Go over them, and they could not obtain this type of short-term consumer credit from any other source except by acquiescing to nearly identical requirements for individual, non-class arbitration. Because of this lack of meaningful consumer choice over these exculpatory contract terms, the Court should find that this mandatory individual arbitration clause is procedurally unconscionable.[14]

This mandatory individual arbitration clause is also substantively unconscionable both because of its exculpatory effects discussed herein, *supra* at 17-22, and because these exculpatory effects are wholly one-sided, falling entirely upon consumers without burdening any of Check 'N Go's rights. Not only is this effectively exculpatory for the reasons discussed herein, but also because the exculpatory effects are wholly one-sided, falling entirely upon consumers without burdening any of Check 'N Go's rights. While the arbitration clause's ban on class actions effectively extinguishes plaintiffs' claims, it has no impact on Check 'N Go's legal rights because lending companies never bring class actions *against* consumers. The California Supreme Court recently described the unfairness of this one-sided waiver of rights as follows:

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[14] For cases finding that the presence or absence of market alternatives is relevant to determining procedural unconscionability, *see Brenner v. Little Red School House, Ltd.*, 302 N.C. 207, 213, 274 S.E.2d 206, 211 (1981) ("Plaintiff was not forced to accept defendant's terms, for there were other private and public schools available to educate the child."); *Ting v. AT&T*, 182 F. Supp. 2d at 929; *American General Finance v. Branch*, 793 So. 2d 738 (Ala. 2000); *Kloss v. Edward D. Jones & Co.*, 54 P.3d 1 (Mont. 2002) (finding lack of choice concerning arbitration in investment brokerage community in Montana); *cf. Alexander v. Anthony Int'l, LP*, 341 F.3d 256, 266 (3d Cir. 2003) (noting limited alternatives for employment among Virgin Islands oil refinery workers whose employer imposed mandatory arbitration clause). For cases finding that arbitration clauses promulgated in similar form contracts on a take-it-or-leave-it basis are procedurally unconscionable, *see Szetela*, 118 Cal. Rptr. 2d at 867; *Discover Bank v. Shea*, 827 A.2d at 365; *Powertel v. Bexley*, 743 So. 2d at 574-75; *cf. Luna*, 236 F. Supp. 2d at 1183 ("A party's status as a consumer is one of those circumstances. Washington courts have recognized that the consumer or commercial nature of a contract should be considered in the unconscionability inquiry.")

> Although styled as a mutual prohibition on representative or class actions, it is difficult to envision the circumstances under which the provision might negatively impact Discover Bank, because credit card companies typically do not sue their customers in class-action lawsuits.

Discover Bank v. Superior Court, 30 Cal. Rptr. 3d at 85 (quoting *Szetela*, 118 Cal. Rptr. 2d at 867).[15] Since North Carolina courts determine substantive unconscionability based on whether non-negotiable contract terms are "unreasonably favorable" to the party that dictated them, *State Farm*, 122 N.C. App. at 73, 468 S.E.2d at 573,[16] the Court should find here that Check 'N Go's one-sided arbitration clause stripping small-loan borrowers of the right to bring class-wide claims while preserving all of Advance America's own foreseeable claims is substantively unconscionable.[17]

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[15] *See also Ting v. AT&T*, 319 F.3d at 1150 ("It is difficult to imagine AT&T bringing a class action against its own customers . . ."); *Luna*, 236 F. Supp. 2d at 1179 ("Although the Arbitration Rider's class action provision is nominally mutual, because there is no reasonable possibility that Household would institute a class action against its borrowers, the provision is effectively one-sided."); *Discover Bank v. Shea*, 827 A.2d 358, 366 (N.J. Super. Ct. 2001) ("The provision against class-wide relief in Discover's amendment benefits only discover, at the expense of individual cardholders. While Discover can use the provision to preclude class actions and, therefore, immunize itself completely from small claims, individual cardholders gain nothing, and in fact, are effectively deprived of their individual small claims.")

[16] *See also Crowder Construction Co. v. Kiser*, 134 N.C. App. 190, 207, 517 S.E.2d 178, 190 (1999) ("[I]f the provisions are then viewed as so one-sided that the contracting party is denied any opportunity for a meaningful choice, the contract should be found unconscionable.") (citation omitted).

[17] In the unlikely event the Court finds that Delaware law applies here (which it does not), the Delaware Supreme Court has struck down a similarly one-sided consumer arbitration clause as unconscionable and against public policy in *Worldwide Ins. Group v. Klopp*, 603 A.2d 788 (Del. 1992). In *Klopp*, the Delaware Supreme Court noted state policy favoring arbitration, but cautioned that arbitration cannot be required where it is "unfairly structured in that its effect is to allow the [company] to avoid a high award whether or not it is fair and just." *Id.* at 790 (citation omitted). The court then struck down the insurer's arbitration system that allowed for de novo appellate review *only* where an award exceeded $15,000 because it was unreasonably favorable to the insurer. *Id.* at 791 ("While high awards may be appealed by either party, common experience suggests that it is unlikely that an insured would appeal such an award.")

Thus, plaintiffs' lack of meaningful choice over the terms of this arbitration clause, combined with the clause's one-sided class action ban extinguishing their small dollar claims while preserving all of Check 'N Go's legal rights, renders this arbitration clause unconscionable.

Check 'N Go's mandatory individual arbitration clause therefore is unenforceable for two separate and independent reasons: (1) It violates North Carolina public policy against adhesive, exculpatory clauses; and (2) it is unconscionable. Therefore, Check 'N Go's motion to compel individual arbitrations should be denied.

II. THE FAA DOES NOT PREEMPT NORTH CAROLINA LAW PROHIBITING ENFORCEMENT OF EXCULPATORY CLAUSES AND CONTRACT TERMS FOUND TO BE UNCONSCIONABLE.

Check 'N Go spends much of its brief arguing that the FAA applies to its mandatory individual arbitration clause and that its application compels enforcement of this clause without regard to whether the clause comports with North Carolina contract law. But this heavy reliance on federal law is misguided because the FAA expressly preserves the application of state contract law, does not preempt any of the arbitration-neutral North Carolina contract law rules discussed herein, and is perfectly consistent with general principles of North Carolina contract law in prohibiting uses of arbitration that are exculpatory. Therefore, the FAA's application to this case does not alter the conclusion that Check 'N Go's mandatory individual arbitration clause violates public policy against exculpatory clauses and is unconscionable under North Carolina contract law.

A. There Is a Strong Presumption Against Finding Federal Preemption of State Contract Law.

Because preemption constitutes a radical intrusion on a state's power, the U.S. Supreme

Court has long recognized a strong presumption against preemption of state laws. In its most recent decision addressing federal preemption questions, the Court explained that:

> Because the States are independent sovereigns in our federal system, we have long presumed that Congress does not cavalierly pre-empt state law causes of action. In areas of traditional state regulation, we assume that a federal statute has not supplanted state law unless Congress has made such an intention clear and manifest.

Bates v. Dow Agrosciences, LLC, 125 S. Ct. 1788, 1801 (2005). North Carolina's common law of contracts and unconscionability are areas of traditional and almost exclusive state regulation. *See, e.g., Erie Railroad Co. v. Tompkins* 304 U.S. 64, 78 (1938) ("Congress has no power to declare substantive rules of common law applicable in a state. . .").

Where a federal statute has no express preemption provision and does not preempt an entire field of regulation, it only preempts state law if there is an "actual conflict," either because it is "impossible for a private party to comply with both . . . requirements," or because the state laws "stand[] as an obstacle to the accomplishment and execution of the full purposes of Congress." *Freightliner Corp. v. Myrick*, 514 U.S. 280, 287 (1995) (citations omitted). But this type of "implied conflict preemption" has no possible application where, as here, there is no federal law standard addressing the subject the state is regulating. *See id.* at 284-85 (holding that state tort law standard calling for antilock brakes on 18-wheel trucks was not preempted, finding that "it is not impossible . . . to comply with both federal and state law because there is simply no federal standard for a private party to comply with."); *id.* at 289-90 ("[a] finding of liability against petitioners would undermine no objectives or purposes with respect to ABS devices, since none exist."); *see also Sprietsma v. Mercury Marine*, 537 U.S. 51, 63-64 (2002) (finding no implied conflict preemption of common law tort claims in the absence of governing federal

regulation).

B. The FAA Preempts Only Those State Laws That Frustrate its Purposes, and Expressly *Saves* General State Contract Law from Preemption.

The FAA has no express preemption provision and does not reflect a congressional intent to occupy the entire field of arbitration or contract law. *Volt Info. Sciences, Inc. v. Bd. of Trustees of Leland Stanford Junior Univ.*, 489 U.S. 468, 477 (1989). Therefore, the FAA only preempts state laws whose application would frustrate the will of Congress by undermining the Act's policy goals by singling out arbitration agreements from other contracts for disfavored treatment. *Id.* at 477-78.

In addition, the FAA contains a savings clause which expressly provides that arbitration clauses will not be enforced if there are grounds under state contract law for invalidating the clause. 9 U.S.C. § 2. The U.S. Supreme Court has recognized that the defense of unconscionability under state contract law is available to a party challenging an arbitration agreement. *Doctor's Assocs., Inc. v. Casarotto* 517 U.S. 681, 687 (1996) ("[G]enerally applicable contract defenses, such as fraud, duress or unconscionability, may be applied to invalidate arbitration agreements without contravening [the F.A.A.].").[18] In other words, state contract law applies to arbitration clauses. *Perry v. Thomas* 482 U.S. 483, 492-93 (1987) ("An agreement to arbitrate is . . . enforceable, *as a matter of federal law*, 'save upon such grounds as exist at law or in equity for the revocation of any contract.' . . . Thus state law, whether of legislative or judicial origin, is applicable if that law arose to cover issues concerning the

[18] *Cf. Allied-Bruce Terminix Cox., Inc. v. Dobson* (1995) 513 U.S. 265, 281 ("States may regulate contracts, including arbitration clauses, under general contract law principles."); *First Options of Chicago, Inc. v. Kaplan*, 514 U.S. 938, 944 (1995) (state law of contract formation determines existence of agreement to arbitrate).

validity, revocability, and enforceability of contracts generally.") (emphasis in original, citations omitted).[19] *See also Discover Bank*, 113 P.3d 1100 (holding that the FAA does not preempt state unconscionability law).

State and federal courts across the country routinely apply these doctrines to strike down arbitration clauses with abusive terms inserted by companies that strip consumers and workers of their rights. While these decisions do not (and cannot) invalidate *all* arbitration clauses, these courts have used equitable principles of state contract law in dozens of cases to draw a line between valid uses of arbitration *as an alternative forum to court* and unconscionable uses of arbitration clauses *as effectively denying individuals of any forum*. An illustrative list of these decisions is enclosed as Exhibit 39.

C. North Carolina Contract Law Prohibiting Exculpatory Class Action Bans Does Not Conflict with the FAA's Policy of Placing Arbitration Clauses on the Same Footing as Other Contracts

While the FAA generally allows parties to enforce agreements providing for arbitration,

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[19] Because the FAA expressly preserves application of generally applicable state contract law, Check 'N Go's heavy reliance on the Fourth Circuit's decision in *Snowden v. CheckPoint Check Cashing*, 290 F.3d 631 (4th Cir. 2002), **Brief at 11, 16-17**, as support for its class action ban is misplaced. In *Snowden*, the Fourth Circuit held that an arbitration clause banning consumer class actions was *not* unconscionable, a holding that reflects the state of the law in Maryland, the state in which the claims in that case arose. *See, e.g., Gilman v. Wheat First Securities*, 692 A.2d 454 (Md. 1997) (upholding Virginia forum selection clause that would bar class actions). This rule of Maryland contract law that was decisive in *Gilman* and *Snowden* has no application here because this case is governed by North Carolina's rather than Maryland's contract law.

federal law says nothing about whether Check 'N Go can include in an arbitration agreement a term barring consumer class actions. Check 'N Go argues to this Court as though federal policy allowing arbitration somehow also allows companies to exempt themselves from class actions whenever they want. But federal law says nothing of the sort.

There is nothing in the FAA requiring that arbitration be conducted on an individual basis. Indeed, the U.S. Supreme Court has held that arbitrations may be conducted on a class action basis. *See Green Tree Fin. Corp. v. Bazzle*, 125 S. Ct. 2402, 2405 (2003) (question of whether arbitration clause allows class actions is "a matter of state law"); *id.* at 2406 ("state law, not federal law, normally governs such matters") (Stevens, J. concurring in the judgment); *see also Discover Bank v. Superior Court*, 113 P.3d 1100, 30 Cal. Rptr. 3d 76, 91 (Cal. 2005) ("[T]here is nothing to indicate that class action and arbitration are inherently incompatible."). As further evidence that arbitrations may be handled on a class-wide basis, the American Arbitration Association has promulgated rules for handling class actions in arbitration, and has in fact handled quite a few cases on a class action basis. *See* American Arbitration Association, Supplementary Rules for Class Arbitrations (available at http://www.adr.org/sp.asp?id=21936).

Likewise, the many cases discussed herein where courts have found arbitration clauses barring consumer class actions unconscionable were pro- rather than anti-arbitration because they created a rule that *encouraged* arbitration of consumer claims that would not be brought under contracts requiring arbitration on an individual basis. *See Discover Bank v. Superior Court*, 30 Cal. Rptr. 3d at 90-91 (criticizing lower court opinion upholding class action ban as reflecting "the very mistrust of arbitration that has been repudiated by the United States Supreme Court.") (citation omitted). Moreover, the lack of any anti-arbitration bias by those courts that struck

down class action bans is shown conclusively by the fact that they applied the same rule that other courts have applied in cases having *nothing to do with arbitration. See, e.g., America Online, Inc. v. Superior Court*, 90 Cal. App. 4th 1, 17-18 (2001) (striking down judicial forum selection and choice of law clause as unconscionable for barring class claims by consumers);[20] *cf. Weiss v. Regal Collections*, 385 F.3d 337, 345 (3d Cir. 2004) (barring defendant from "picking off" named plaintiff in class action with Rule 68 offer of judgment because practice would prevent consumers from bringing class-wide claims).

At bottom, Check 'N Go's motion to compel individual arbitrations isn't about arbitration at all, but about exculpation. If the Court refuses to enforce this arbitration clause, Check 'N Go would be able to write a new, legal contract and in the future hold all of their North Carolina customers to mandatory binding arbitration clauses if it so desires. The one thing that Check 'N Go cannot do, however, whether in court or arbitration, is take away from customers the ability to vindicate substantive rights by seeking class-wide relief through class action proceedings (whether in arbitration or in court). No one denies that the drafter of any contract could both require arbitration *and* Am. Comply with the rule of law set forth in cases such as *Szetela*, *Ting* and *AOL*, merely by expressly providing that arbitrations could proceed on a class-wide basis. This fact alone demonstrates that state law prohibiting contractual bans on class actions

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[20] *See also America Online, Inc. v. Pasieka*, 870 So. 2d 170, 171-72 (Fla. Dist. Ct. App. 2004) (following California *AOL* case); *Dix v. ICT Group, Inc.*, 106 P.3d 841, 845 (Wash. App. 2005) ("Requiring Ms. Dix and Mr. Smith to litigate their [Consumer Protection Act] claim in Virginia without the benefit of a class action procedure as is allowed in Washington . . . undermines the very purpose of the CFA, which is to offer broad protection to the citizens of Washington.")

withstands the FAA.

D. North Carolina Contract Law Prohibiting Exculpatory Contracts is Consistent with U.S. Supreme Court Cases Disallowing Exculpation Under the FAA.

As set forth above, North Carolina law may only be found to be preempted by the FAA if it conflicts with Congress' purposes in enacting the FAA to such an extent that North Carolina law is an obstacle to the enforcement of federal law. In fact, North Carolina's law prohibiting exculpatory clauses is entirely consistent with the purposes of the FAA, as articulated by the U.S. Supreme Court. The Court has directed that arbitration clauses are enforceable under the FAA only if they make proceedings accessible so that claimants can effectively enforce their rights. *See, e.g., Gilmer v. Interstate/Johnson Lane Corp.* 500 U.S. 20, 26 (1991) (citation omitted) ("[B]y 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."). As an illustration of this principle, the Court has recognized that "the existence of large arbitration costs may well preclude a litigant . . . from effectively vindicating [its] rights," *Green Tree Financial Corp. v. Randolph* 531 U.S. 79, 81 (2000). The Court also has stated that arbitration is acceptable as an alternative to courts because it is simply a "different forum" – one with somewhat different and simplified rules – but nonetheless one where the basic mechanisms for obtaining justice permit a party to "effectively vindicate" his or her rights. *See, e.g., Equal Employment Opportunity Comm'n v. Waffle House, Inc.* 534 U.S. 279, 295 n.10 (2002).

Numerous other federal and state courts have held that particularly unfair or exculpatory arbitration clauses may be struck down without violating the FAA. In *Ting*, for example, the U.S. Court of Appeals for the Ninth Circuit flatly stated that "[w]e recognize, . . . that the FAA

preempts state laws of limited applicability, . . . but we follow well settled Supreme Court precedent in rejecting the proposition that unconscionability is one of those laws." *Ting*, 319 F.3d at 1150, n. 15. In *Ticknor v. Choice Hotels Int'l, Inc.* 265 F.3d 931 (9th Cir. 2001), similarly, the defendant argued that the FAA preempts state laws of unconscionability as they relate to arbitration clauses. The Ninth Circuit rejected that argument for reasons that apply here: "Montana law pertaining to the unconscionability of arbitration clauses was the result of 'the application of general principles that exist at law or in equity for the revocation of any contract.'" *Ticknor*, 265 F.3d at 941, citing *Iwen,* 977 P.2d at 996.

These cases thus demonstrate that, notwithstanding the FAA, the anti-exculpatory and unconscionability principles of North Carolina law apply with full force to Check 'N Go's mandatory individual arbitration clause. The arbitration clause is therefore unenforceable, and the motion to compel individual arbitrations should be denied.

III. CHECK 'N GO'S ARBITRATION CLAUSE IS UNENFORCEABLE BECAUSE IT IS PART OF AN ILLEGAL CONTRACT THAT IS VOID *AB INITIO* AND NEVER CAME INTO EXISTENCE

Additionally, there is no valid agreement to arbitrate because the arbitration clause at issue is part of an illegal contract that is void *ab initio*, and therefore none of its provisions – including the arbitration clause – ever came into existence.

A. Under General Principles of North Carolina Contract Law, Illegal Contracts Are Void *Ab Initio* and Unenforceable.

It is a longstanding rule of general North Carolina contract law that contracts entered into for an illegal purpose and in violation of state statutes are void *ab initio* and cannot be enforced. *See Cauble v. Trexler*, 227 N.C. 307, 311, 42 S.E.2d 77, 80 (1947) ("Hence an agreement which violates a provision of a statute or which cannot be performed without a violation of such a

provision is illegal and void."); *Pierce v. Cobb*, 161 N.C. 300, 77 S.E. 350, 350-51 (N.C. 1913). This principle continues to be applied today. *See, e.g., Carolina Water Serv., Inc. v. Town of Pine Knoll Shores*, 145 N.C. App. 686, 689, 551 S.E.2d 558, 560 (2001).

The reason that a void *ab initio* contract cannot be enforced is because it is non-existent: a contract that is void *ab initio* is considered not to have any legal force. "A void contract is no contract at all; it binds no one and is a mere nullity." *Bryan Builders Supply v. Midyette*, 274 N.C. 264, 270, 162 S.E.2d 507, 511 (1968) (quoting *Am. Jur. 2d Contracts*, § 7); *see also Sphere Drake Ins. Ltd. v. Clarendon Nat'l Ins. Co.*, 263 F.3d 26, 31 (2d Cir. 2001) (noting that the term "void contract" is a misnomer, "for '[i]f an agreement is void, it cannot be a contract." quoting 1 Samuel Williston & Richard A. Lord, *A Treatise on the Law of Contracts*, § 1:20, at 49 (4th ed. 1990)). Because an agreement that is illegal and void does not exist, no part of it can be carried out, as no party should be permitted to benefit from an illegal act. *See Lamm v. Crumpler*, 242 N.C. 438, 442, 88 S.E. 2d 83, 86 (1955).[21] Moreover, a court will not lend its assistance to any party to an illegal transaction. *See id.* at 443; *Cobb*, 161 N.C. 300 at 302, 77 S.E.2d 350..

[21] Although the general rule is that no part of an illegal contract will be enforced, the non-offending provisions of an illegal contract can be enforced if the illegal part of the contract "does not constitute the main or essential feature or purpose of the agreement." *Rose v. Vulcan Materials Co.*, 282 N.C. 643, 658 (N.C. 1973). That exception is inapplicable here, however, because the main purpose of the agreement – the payday loan transaction – is precisely the part of the agreement plaintiffs allege to be illegal.

It stands to reason that, just as every other provision of a contract that is illegal and void *ab initio* is unenforceable, an arbitration clause included in an illegal contract is void and unenforceable. Several courts have refused to enforce arbitration clauses contained in contracts alleged to be illegal. In *Cardegna v. Buckeye Check Cashing, Inc.*, 894 So.2d 860 (Fla. 2005), *cert. granted*, 125 S.Ct. 2937 (2005),[22] for example, the Florida Supreme Court refused to enforce in arbitration clause in a payday lending contract that was illegal under Florida law, holding that "an arbitration provision contained in a contract which is void under Florida law cannot be separately enforced while there is a claim pending in a Florida trial court that the arbitration clause containing the arbitration provision is itself illegal and void *ab initio*." *Id.*; *see also Alabama Catalog Sales v. Harris*, 794 So.2d 312, 317 (Ala. 2000) (holding that, in a case challenging the legality of payday loan contracts with arbitration clauses, "if the contracts are void and unenforceable, no claims arising out of or relating to the contracts are subject to arbitration"); *Sandvik v. Advent Int'l Group*, 220 F.2d 99, 108 (3d Cir. 2000); *Onvoy, Inc. v. Shal, LLC*, 669 N.W.2d 344, 354 (Minn. 2003). The reason for this is simple: arbitration is a creature of contract, and without a valid contract, there is no authority for an arbitrator to act. *See EEOC v. Waffle House, Inc.*, 534 U.S. 279, 293-94 (2002). As the Seventh Circuit succinctly stated with respect to arbitration: "No contract, no power." *Sphere Drake Ins., Ltd. v. All American Ins. Co.*, 256 F.3d 587, 591 (7th Cir. 2001); *see I.S. Joseph Co., Inc. v. Mich. Sugar Co.*, 803 F.2d 396, 399 (8th Cir. 1986) (noting that arbitrator has no source of authority outside

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[22] On June 20, 2005, the United States Supreme Court granted *certiorari* in *Cardegna* in order to determine whether, as a matter of federal law, an arbitration clause in an illegal and void *ab initio* contract can be enforced. 125 S.Ct. 2937. Because of the factual similarity between this case and *Cardegna*, in that both cases involve the enforceability of arbitration clauses in illegal payday loan contracts, the Court's ruling may provide instruction as to the enforceability of the arbitration clauses at issue here.

the agreement of the parties). Thus, without a valid contract, there is no valid agreement to arbitrate, and plaintiffs' claims cannot be forced into arbitration.

B. Plaintiffs Have Alleged Colorable Claims That The Payday Loan Agreements At Issue Are Illegal and Void *Ab Initio*.

In this case, defendants cannot enforce their illegal contract's arbitration clause because the entire contract is illegal and void. The arbitration clauses at issue are contained in plaintiffs' payday loan contracts. These contracts are illegal and void. Since at least 1992, when the North Carolina Attorney General issued an opinion declaring that payday lending violates the North Carolina Consumer Finance Act, G.S. § 53-166 as well as G.S. § 14-107, defendants have known that their payday loan contracts have an illegal purpose. *See* 60 N.C. Op. Atty. Gen. 86 (Jan. 24, 1992). Moreover, the State Commissioner of Banks currently is considering whether industry rival Check 'N Go's payday loan contracts violate the Consumer Finance Act, and is set to rule on that question next month. Thus, the forthcoming ruling from the Commissioner of Banks will determine whether defendants' payday loan contracts are illegal and void.

Additionally, plaintiffs have specifically alleged in the Am. Complaint that defendants' loan contracts were made for an illegal purpose and violate various North Carolina statutes, including § 53-166 and the North Carolina Unfair Trade Practices Act, § 75-1.1. Plaintiffs have alleged colorable claims that Check 'N Go's loans run afoul of these statutes and thus are illegal and void. Because plaintiffs allege that their payday loan agreements are illegal and void *ab initio*, Check 'N Go's efforts to compel arbitration arising from those agreements must be rejected.

C. Refusing To Enforce Defendants' Arbitration Clauses Comports With Federal Law.

Finally, no principle of federal law overrides this rule of North Carolina contract law that illegal contracts are void to require enforcement of an arbitration clause contained in a void contract. Plaintiffs' position that the arbitration clauses here are part of an illegal contract and cannot be enforced is consistent with the United States Supreme Court's decision in *Prima Paint Corp. v. Flood & Conklin Mfg. Co.*, 388 U.S. 395 (1967). In that case, the Court held that when a party alleges that an arbitration clause is unenforceable because it is contained in a contract that was fraudulently induced, the argument as to whether the contract is fraudulently induced must be decided by an arbitrator rather than by a court. *See id.* at 403-04. The Court established what is now known as the "separability" doctrine, holding that with respect to validly-created contracts, challenges directed at the contract as a whole are decided by an arbitrator while challenges directed specifically at the arbitration clause are decided by a court. *See id.*

The *Prima Paint* rule is inapplicable here because it applies only to voidable contracts, not contracts that are void *ab initio*. *Prima Paint* involved a contract alleged to be voidable on the ground that it was fraudulently induced. Unlike a contract that is void *ab initio*, a voidable contract exists as an enforceable contract subject to ratification or rejection by one of the parties to the agreement. *See, e.g.*, Restatement (Second) Contracts, § 7. Therefore, because an arbitration clause embedded in a voidable contract has come into existence, disputes as to the enforceability of the contract as a whole can be sent to arbitration. A void *ab initio* contract, by contrast, never came into being and therefore no basis exists for enforcing the arbitration agreement contained within it. Consequently, a number of courts have held that the *Prima Paint* separability rule applies only to voidable contracts, and not to contracts that are void *ab initio*. *See, e.g.*, *Cardegna*, 894 So.2d 860 (holding that *Prima Paint* does not apply to a challenge to

the legality of a payday loan contract); *Onvoy, Inc.*, 669 N.W.2d 344; *Harris*, 794 So.2d at 316-17 (refusing to apply *Prima Paint* rule to challenge to the legality of a payday loan contract).[23] Thus, *Prima Paint* does not require this case to be sent to arbitration.[24]

Indeed, to apply *Prima Paint* here would disrupt general principles of North Carolina contract law by creating a special rule making arbitration clauses enforceable in situations where no other contractual provision would be enforced. Such a rule is improper for two reasons. First, it would allow the defendants unfairly to benefit from their illegal activities by enforcing the arbitration clause in an illegal contract. *See Lamm*, 242 N.C. at 442-43. Under defendants'

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[23] *Weis Builders, Inc. v. Kay S. Brown Living Trust*, 236 F. Supp. 2d 1197, 1203-04 (D. Colo. 2002); *Sandvik v. Advent Int'l Group*, 220 F.3d 99 (3d Cir. 2000); *Sphere Drake*, 263 F.3d at 31-32; *Sphere Drake*, 256 F.3d at 589-91; *Three Valleys Municipal Water Dist. v. E.F. Hutton & Co.*, 925 F.2d 1136, 1140-41 (9th Cir. 1991); *I.S. Joseph*, 803 F.2d at 399-400; *Pittsfield Weaving Co., Inc. v. Grove Textiles, Inc.*, 430 A.2d 638 (N.H. 1981); *cf. Hotels Nevada v. Bridge Banc, LLC*, __Cal.Rptr.3d__, 2005 WL 1595278 (Cal. App. July 8, 2005) (holding that in a case governed by the FAA, "[u]nder California law, the question whether the contract as a whole is illegal is one for the court to decide").

[24] A few courts, including the Fourth Circuit, have held that *Prima Paint* requires that claims alleging that a contract as a whole is illegal and void *ab initio* be decided by an arbitrator. *See, e.g.*, *Snowden v. Checkpoint Check Cashing*, 290 F.3d 631, 637-38 (4th Cir. 2002); *Bess v. Check Express*, 294 F.3d 1298, 1305-06 (11th Cir. 2002); *Burden v. Check Into Cash*, 267 F.3d 483 (6th Cir. 2001); *cf. Keel v. Private Business, Inc.*, 594 S.E.2d 796, 798-99 (N.C. App. 2004) (acknowledging the separability doctrine). These courts have distinguished between contracts that are void because a party never assented to the agreement in the first place, and contracts that are void because they violate a statutory provision. Under North Carolina law, both contracts that lack assent and contracts that violate a voiding statute are "void." See Marriott *Financial Services v. Capitol Funds, Inc.*, 288 N.C. 122, 128, 217 S.E.2d 551, 555 (1975) ("The general rule is that an agreement which violates a constitutional statute or municipal ordinance is illegal and void."); Mazda Motors of America, Inc. v. Southwestern Motors, Inc., 36 N.C. App. 1, 14, 243 S.E.2d 793, 802 (1978), *reversed* 296 N.C. 357, 250 S.E.2d 250 (1979) on ground of legislative intent as to meaning and effect of N.C.G.S. § 20-305(6) ("As failure to give the required notice to the Commissioner was unlawful, the "voluntary agreement" without such notice was contrary to the statutory provisions and, thereby, to public policy. It was therefore illegal and void ab initio. 3 Strong, N.C. Index 3d, Contracts, s 6, pp. 374-5."). In contrast, N.C.G.S. § 53-166(d) is clear and unambiguous: contracts in violation "shall be void." In fact, the reasoning of those courts distinguishing between lack of assent and illegality does not appear to be grounded in any recognized principle of contract law, and has received criticism for that very reason. *See Match-E-Be-Nash-She-Wish Band of Pottawatomi Indians v. Kean-Argovitz Resorts*, 383 F.3d 512, 518-21 (6th Cir. 2004) (Cleland, J., concurring).

interpretation, a person who included an arbitration clause in a contract to sell crack cocaine or to carry out a murder would be allowed to demand that any question over the contract's legality be decided in accordance with that contract's arbitration clause. Second, carving out a unique exception for arbitration clauses turns on its head the cardinal purpose of the Federal Arbitration Act which is to "make arbitration agreements as enforceable as other contracts, but not more so." *Prima Paint*, 388 U.S. at 404 n.12.

The separability rule of *Prima Paint* also does not apply here because the rule only governs proceedings in federal court, not in state court. In determining the ultimate question at issue in *Prima Paint* – whether the arbitration clause was severable from the rest of the contract – the Court held that the separability doctrine derives from § 4 of the FAA, which requires a court to order a dispute into arbitration, if "the making of the agreement for arbitration or the failure to Am. Comply (with the arbitration agreement) is not in issue." *Prima Paint*, 388 U.S. at 403. The Court determined that because a challenge to the contract as a whole rather than just to the arbitration agreement does not put in issue the making of the arbitration agreement, Section 4 requires the challenge to be sent to arbitration. *See id.* at 403-04 ("But the statutory language [of § 4] does not permit the *federal court* to consider claims of fraud in the inducement of the contract generally." (emphasis added)). The Court never indicated that its decision rested on § 2 of the Act, or any of the other of the Act's substantive provisions.

Section 4 of the FAA, by its own terms, is a procedural rule that applies only to actions brought in federal court, and therefore the *Prima Paint* rule, which is an interpretation of Section 4, does not apply here. Section 4 states that a party aggrieved by a failure to arbitrate may petition to compel arbitration in "any United States district court" that would otherwise have

jurisdiction, and that service of the petition shall be governed by the Federal Rules of Civil Procedure. 9 U.S.C. § 4. The statutory language clearly limits its application to federal court, and the Supreme Court has emphasized that "we have never held that §§ 3 and 4 [of the FAA], which by their terms appear to apply only to proceedings in federal court, are nonetheless applicable in state court." *Volt Info. Sciences, Inc. v. Bd. of Trustees of Leland Stanford Junior Univ.*, 489 U.S. 468, 476 n.6 (1989). Building on both the plain language and the Supreme Court's interpretation of the Act, other courts have also held that the reach of § 4 does not extend to state courts. *See Wells v. Chevy Chase Bank*, 768 A.2d 620, 625-26 (Md. 2001).

This conclusion that the *Prima Paint* rule applies only in federal courts is confirmed by *Prima Paint* itself. There, the Court emphasized that its holding was directed toward federal courts, stating that it was merely deciding "whether Congress may prescribe how *federal courts* are to conduct themselves with respect to subject matter over which Congress plainly has the power to legislate." *Prima Paint*, 388 U.S. at 405 (emphasis added). Since *Prima Paint* does not apply in state court, it does not overturn well-settled principles of North Carolina contract law that illegal contracts are void *ab initio* and unenforceable.[25] Because the contracts containing the arbitration clauses at issue here never came into existence, plaintiffs' claims cannot be sent into arbitration.

III. CNG'S ARBITRATION CLAUSE IS UNCONSCIONABLE BECAUSE IT REQUIRES ITS CUSTOMERS TO SUBMIT ALL OF THEIR CLAIMS TO NAF.

[25] Although some North Carolina courts have referred to the severability doctrine of *Prima Paint*, *see Keel v. Private Business, Inc.*, 163 N.C. App. 703, 705-06 (N.C. App. 2004); *Eddings v. S. Orthopaedic & Musculoskeletal Assocs.*, 605 S.E.2d 680, 684 (N.C. App. 2004), in neither case did the court address the question of whether the doctrine is binding on state courts in addition to federal courts. Specifically, neither court considered whether the *Prima Paint* rule derived from FAA § 4 and therefore was limited only to federal courts.

A. FEDERAL AND NORTH CAROLINA CONSTITUTIONAL LAW RECOGNIZE A RIGHT TO A SYSTEM DESIGNED TO PRODUCE A NEUTRAL DECISION MAKER.

The North Carolina State Constitution requires "remedy by due process of law" for all injured parties, as well as the administration of justice "without favor." N.C.G.S.A. Art. I, § 18. The Supreme Court of North Carolina has interpreted this due process guarantee, citing the United States Constitution, as requiring an impartial decision-maker. *County of Lancaster v. Mecklenburg County*, 334 N.C. 496, 511 (1993). In that case, the Court articulated a test for impartiality, holding that "an elected official with a direct and substantial financial interest in a zoning decision may not participate in making that decision." *Id.* Further, "[w]here there is a specific, substantial, and readily identifiable financial impact on a member, nonparticipation is required." *Id.*

In *County of Lancaster*, the court considered a scenario in which a request for a zoning permit was submitted to the Zoning Administrator, whose job security was alleged to be dependent upon the good graces of the Board of Commissions, the party making the request for a zoning permit. *Id.* at 500. In *County of Lancaster*, however, the court found no due process violation because the decision-maker's job security was "protected by certain personnel policies and regulations, which would prohibit the termination or demotion of Mr. Brandon by his supervisors except for cause." *Id.*

The United States Supreme Court has embraced the fundamental principle that decision makers should not be tainted by a financial interest in *Ward v. Village of Monroeville*, 409 U.S. 57 (1972). That case involved a mayor who had overall authority over the village affairs; the

village's income derived, in large part, upon "the fines, forfeitures, costs and fees imposed by him in his mayor's court." 409 U.S. at 58. Even though the mayor did not personally profit from fines levied against alleged violators, the Court found that "'possible temptation' may also exist when the mayor's executive responsibilities for village finances may make him partisan to maintain the high level of contribution from the mayor's court." *Id.* at 60. Similarly, in this case, Check N Go's arbitration system makes the officials running the NAF (who select the arbitrators and operate the system), and the arbitrators themselves, dependent upon Check N Go's continued good will for continued income.

In California, similarly, a fee-per-case systems for judicial decision makers violate due process. In *Haas v. County of San Bernadino*, the California Supreme Court recognized the fundamental concept that "'[a] fair trial in a fair tribunal is a basic requirement of due process.'" 27 Cal.4th 1017, 1025 (2002) (citation omitted). Consistent with this fundamental right, the Court held unconstitutional a system that allowed counties to select temporary administrative hearing officers on an *ad hoc* basis, paying them according to the number and duration of their cases:

> The requirements of due process are flexible, especially where administrative procedure is concerned, but they are strict in condemning the risk of bias that arises when an adjudicator's future income from judging depends on the goodwill of frequent litigants who pay the adjudicator's fee.

Id. at 1037. The court in *Haas* made clear that "The risk of bias caused by financial interest need not manifest itself in overtly prejudiced, automatic rulings in favor of the party who selects the arbitrator." 27 Cal.4th at 1030. However, "that such a temptation can arise from the hope of future employment as an adjudicator is easy to understand and impossible in good faith to deny."

Id.

B. North Carolina State Contract Law Should Find Unconscionable Any Contract of Adhesion that Requires a Consumer to Submit His or Her Claims to A Decision Maker With an Incentive to Favor the Stronger Party.

Ward and *Haas* both involved state actors, and thus the cases turned on a finding of unconstitutionality, not unconscionability. However, it should be beyond argument that an adjudicative system that is so biased as to be unconstitutional when imposed by powerful state actors must also be unconscionable when imposed by powerful corporations against individual litigants. This was the crux of a recent opinion from the West Virginia Supreme Court, which cited *Haas* for the proposition that "an impermissible structural unfairness in a tribunal, *be it judicial or arbitral*, would be presumed where the decision-maker is designated by one of the parties to a dispute and where the person making the decisions is compensated on a fee-per-case." *State ex rel Dunlap v. Berger*, 567 S.E.2d 265 (W.Va. 2002) (emphasis added); *see also Toppings v. Meritech Mortgage Servs. Inc.*, 569 S.E.2d 149 (2002) (extending the reasoning in a West Virginia case involving the unconstitutionality of a statute giving judicial officials a pecuniary interest in their cases to the context of private arbitration, and holding that an arbitration system in which disputes were submitted to an arbitration service provider compensated on a per-case basis "so impinges on neutrality and fundamental fairness that it is unconscionable and unenforceable under West Virginia law."). Accordingly, plaintiffs urge this Court to apply the principles of *County of Lancaster*, *Ward* and *Haas* in the way that the West Virginia Supreme Court did in *Toppings*, and hold that just as such a system would be unconstitutional if imposed by state actors, it is unconscionable when imposed by private actors such as Check N Go, and it must not be enforced under North Carolina law.

While there are no North Carolina cases on the point, it is well established in other jurisdictions that arbitration clauses which require arbitration by non-neutral arbitrators are unconscionable. In *Graham v. Scissor-Tail*, for example, the California Supreme Court held a person cannot serve as an arbitrator if "his interests are so allied with those of [a] party that, for all practical purposes, he is subject to the same disabilities which prevent the party [to the contract] himself from serving." 28 Cal.3d. 807, 827 (1981). The court concluded the designated arbitrator in that case could not be expected to arbitrate with the required degree of "disinterestedness and impartiality," and refused to enforce the arbitration clause before it. *Id.* at 828.

Many other courts have refused to compel arbitration in settings where the arbitrators' neutrality were compromised. In *Hooters of America, Inc. v. Phillips*, 173 F.3d 933 (4th Cir. 1999), the Fourth Circuit refused to compel arbitration in a case where an employer's arbitration rules were "crafted to ensure a biased decisionmaker." *Id.* at 938. Noting that the employer had complete control over the selection of two of the three arbitrators on a panel, to the point where even managers of the employer could be on the list of arbitrators, the court noted that "the selection of an impartial decisionmaker would be a surprising result." *Id.* at 939. Accordingly, the court (which in general expressed fervent admiration for arbitration) held that the employer had created "a sham system unworthy even of the name of arbitration," and thus held that the employer had breached its contractual obligation to provide an impartial arbitral forum. *See also Hudson v. Chicago Teachers Union Local No. 1*, 743 F.2d 1187 (7th Cir. 1984), *aff'd*, 475 U.S. 292 (1986) (arbitrator not independent where she or he was to be picked by and paid by union); *Cheng-Canindan v. Renaissance Hotel Assocs.*, 57 Cal. Rptr. 2d 867 (Ct. App. 1996), *rev.*

denied, 1997 Cal. LEXIS 817 (1997) (procedure was so dominated by an employer that it did not even qualify as arbitration and would not be compelled); *Ditto v. Re/Max Preferred Properties, Inc.*, 861 P.2d 1000 (Okla. Ct. App. 1993) (where only one party had a voice in selection of arbitrator, clause would not be enforced); *In re Cross & Brown Co.*, 167 N.Y.S.2d 573, 575 (App. Div. 1957) (not enforcing an arbitration agreement between a real estate broker and his employer because it appointed the employer's Board of Directors as arbitrator. This contravened the "well-recognized principle of 'natural justice' that a man may not be a judge in his own cause.").

It is important to note that these courts have struck down these arbitration clauses due to concerns with structural bias, and did not require a showing that a particular arbitrator was corrupt. According to many lender defendants who have defended against arbitrator bias challenges, it is not enough that an arbitration system is structured in an unfair way, instead a consumer must prove that the arbitrator appointed to a given case is personally corrupt. In fact, as the prior illustrations establish, many courts have not held themselves to such an impossible standard of specificity. One example brings this conclusion home with particular force, however. When the Fourth Circuit held it was not legal for Hooters Restaurant's arbitration clause to make it possible for a Hooters manager to decide a sexual harassment case against Hooters, the court did not initiate an inquiry into the purity of heart and good intentions of each Hooters manager. Instead, the Court flatly declared that Hooters's system had a basic level of unfairness built into the system and declared it to be illegal. *See Hooters*, 173 F.3d at 938-40.

C. Check N Go's Arbitration Clause Requires Consumers to Submit their Claims to An Arbitration Company With An Incentive to Favor Check N Go.

As set forth above, NAF and its arbitrators only get paid if the corporations who write arbitration clauses – and particularly the lenders on whom NAF relies for most of its income – continue to bring cases to it. Accordingly, Check N Go's system – which unlike Advance America or Check Into Cash, requires consumers to submit their claims to the NAF alone – makes the NAF directly dependent upon repeat business from a lender. If Check N Go is unhappy with NAF's results, it can simply name another arbitration corporation who wants its business even more desperately (if that can be imagined). Accordingly, NAF is a decision-maker "with a direct and substantial interest" in the outcome of a decision in a dispute. As a result, it should be prohibited from participation in making that decision, for the same reasons that the court in *County of Lancaster* delineated in considering the role of an elected official. In any case involving the resolution of disputes between parties, there is a state interest in the administration of justice "without favor," under the North Carolina State Constitution. N.C.G.S.A. Art. I, § 18. An arbitration company whose livelihood is directly linked to its making lender-favorable decisions betrays "a specific, substantial, and readily identifiable financial impact" on the arbitration company, as a result of its decisions, and it should therefore fail the tests of impartiality both under the North Carolina Supreme Court's test for impartiality in *County of Lancaster* and the due process requirement of the State Constitution.

Where, as here, the neutrality of an arbitration service provider is likely compromised because of the incentive inherent in a system whereby a powerful corporate party imposes its own chosen arbitration service that is paid on a fee-per-case basis, arbitration does not operate as a fair substitute to a judicial forum. An arbitration clause that compels arbitration before an arbitrator who is designated by one party and who is paid under a fee-per-case system is

substantively unfair and therefore unconscionable under North Carolina law.

A number of authorities have noted that the generally applicable principles set forth in *Ward*, *County of Lancaster* and *Haas* apply commentators are equally true with respect to arbitrators. NAF is only one of several large arbitration service providers, all competing for the same business. In this competitive marketplace, an obvious implication hangs over NAF's business like a cloud: were it to rule against a large company, such as a franchisor, too often (from the franchisor's viewpoint), or in too great an amount, then franchisors could easily take their business to other arbitration service providers. As one commentator has written:

> [A]rbitrators may be consciously or unconsciously influenced by the fact that the company, rather than the consumer, is a potential source of repeat business. An arbitrator who issues a large punitive damages award against a company may not get chosen again by that company or others who hear of the award.

Jean Sternlight, *Panacea or Corporation Tool? Debunking the Supreme Court's Preference for Binding Arbitration*, 74 WASH. U.L.Q. 637, 685 (1996) (footnote omitted).

One court recognized this "repeat player" problem in an arbitration clause that, like the one here, allowed the stronger party to pick the arbitration forum, and the arbitral forum to select a closed list of arbitrators for any dispute taken to that forum. In *Mercuro v. Superior Court*, 96 Cal. App. 4th 167 (2002), the court examined an employment contract that required arbitration before the NAF, which then provided parties with a list of its arbitrators from which they could choose one. The plaintiff argued that this system did not guarantee a neutral arbitrator, given the size of the defendant's business and the likelihood that it would enlist the NAF in multiple arbitration proceedings, whereas the employee himself would only participate in this one arbitration. *Id.* at 178. The Court there agreed that "The fact an employer repeatedly appears before the same group of arbitrators conveys distinct advantages over the individual employee.

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.* The court found that this factor, in combination with the general lack of mutuality in the arbitration provision, rendered the provision substantively unconscionable. *Id.* at 179

The Equal Employment Opportunity Commission, similarly has stated in the employment context, "results cannot but be influenced by the fact that the employer, and not the employee, is a potential source of future business for the arbitration." Gilbert F. Caselias, *Policy Statement on Mandatory Binding Arbitration of Employment Discrimination Disputes as a Condition of Employment*, 11 EEOC COMPLIANCE MANUAL at 8 (July 10, 1997); *see also* Richard C. Rueben, *The Dark Side of ADR*, CAL. LAW. 53, 54 (Feb. 1994) (quoting an attorney experienced in litigating arbitration claims as stating, "Anytime you are paying someone by the hour to decide the rights and liabilities of litigants, and that person is dependent for future business on maintaining good will with those who will bring him business, you've got a system that is corrupt at its core"); David Schwartz, *Enforcing Small Print to Protect Big Business: Employee and Consumer Rights Claims in an Age of Compelled Arbitration*, 1997 WISC. L. REV. 33, 61 ("[T]he independent arbitration companies have an economic interest in being looked on kindly by large institutional corporate defendants who can bring repeat business.").[26]

It is important to note that this "repeat player" problem is not endemic to arbitration, but

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[26] A study of the results of arbitration in HMOs supports this concern. The study found that with respect to "repeat player" bias issue, in every instance where an arbitrator awarded a plaintiff (generally raising medical malpractice claims) over $1 million "the arbitrator was only employed in that case." MARCUS NIETO AND MARGARET HOSEL, ARBITRATION IN CALIFORNIA MANAGED HEALTH CARE SYSTEMS at 22-23 (2000).

rather occurs as a result of arbitration clauses that single out one arbitration provider as the sole provider for all adjudicative services for a particular company. Thus plaintiffs' argument here is not a generalized attack on arbitration, but rather an argument that a specific system – one that operates on a fee-per-case compensation basis and where one party selects the arbitral forum – is inherently biased and unconscionable under North Carolina law.

D. The Bias Issue Here Is Not Inherent to Arbitration, But Arises From Check N Go's Misuse and Abuse of the Arbitration Forum.

It would have been easy for Check N Go to draft an arbitration clause that gave the parties a choice among, for example, the three largest arbitration providers in the country: the AAA, the National Arbitration Forum, and JAMS. Such a clause would take away any incentive for one provider to curry favor with the contract drafter, since the other party would likely not then select that provider to arbitrate her dispute. Such clauses are used by several other defendants in companion cases to this one, including Advance America and Check Into Cash. They are also used by a number of other companies across the U.S.[27]

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[27] For evidence that a great many companies have adopted arbitration clauses that give consumers a choice of multiple arbitration service providers, see, e.g., NATIONAL CONSUMER LAW CENTER, CONSUMER ARBITRATION AGREEMENTS: ENFORCEABILITY AND OTHER TOPICS (2d ed. 2002) (CD rom accompanying book) (contains copies of arbitration clauses with a choice of several providers by companies such as Beneficial Mississippi (second agreement), Capital One, Chase Manhattan, Citibank, Citifinancial, Discover Financial Services, Fleet, Household, JC Penney Card, MCI, Monogram Credit Card Bank of Georgia, Sears National Bank, Shell Credit, Universal Bank).

However, Check N Go did not include such a clause, and instead drafted an agreement in which the arbitration provider, NAF, is designated by only one party, and NAF then provides a closed list of arbitrators for the parties to select. This is precisely the systematic flaw identified in cases such as *Toppings* and *Mercuro*: NAF and its arbitrators have a pecuniary interest in the cases they hear, and if they rule against the corporations very often, they will risk losing that business to one of the other large arbitration providers such as AAA or JAMS. In short, Check N Go' arbitration system encourages arbitrators to rule in favor of lenders, rather than "bite the hand that feeds them."

An arbitration system like the one at issue here – in which arbitrators are compensated through a fee-per-case system and one party selects the decision maker forum – is inherently biased on its face, making the facts concerning any individual such system unnecessary to the ultimate question. But the practical importance of this legal question becomes clear from the factual record, which contains substantial evidence that the arbitration service provider at issue in this case – the for-profit NAF – has been profoundly influenced by the market reality that its business depends upon referrals from and the good favor of lenders.

E. NAF's Conduct Demonstrates the Pitfalls Inherent in a Biased Arbitration System that Has a Built-in Incentive to Favor One Party.

There is an inherent bias in the fee-per-case system, creating an incentive for NAF arbitrators to rule for lenders in order to garner repeat business. In addition to employing a system with this general structural defect, NAF's behavior exemplifies the concerns highlighted in cases such as *Ward* and *County of Landcaster*. As the Statement of Facts sets forth in great detail, in a series of improper communications, NAF has repeatedly made clear that it sees its role as one of helping corporate lenders reduce and resist legitimate claims brought by their

consumers. The NAF's recurring approach is not that of an entity committed to even-handed judging of disputes, but instead that of a for-profit vendor soliciting lucrative work by advising lenders how it can help them reduce their liabilities (*i.e.*, avoid the "risks of the jury system"). NAF's solicitation letters and advertisements are frankly inappropriate. If this Court were to solicit parties to bring their cases before it with promises that it would "improve their bottom line" and discourage its opponents, this Court would quickly run afoul of North Carolina's ethics rules. If this Court were to issue press relies crowing when it ruled for famous parties and against smaller concerns, the same would occur. The documents described in the Statement of Facts and attached hereto establish that the NAF operates without any concern to such ethical rules, however. Check N Go seeks to have NAF replace the civil justice system for any disputes involving the lender defendants. But while NAF would supplant the publicly accountable system of courts and juries, it has not held itself to the same ethical standards imposed upon courts and juries.

NAF's pro-lender litigation activities also support an inference as to its bias. It is scarcely a coincidence that dozens of lenders would endorse NAF, or that lenders and their counsel would line up to give testimonials of NAF for use in its solicitations to still other lenders. What lender would not? As set forth in the Statement of Facts, NAF's system is structured in a manner not to provide a fair and equitable forum to resolve legal disputes without the expense of a lawsuit, but rather in a manner that serves as a thinly veiled attempt to ensure an end result favorable to NAF's clients, the financial service industry. NAF features its rules – and results – prominently in its literature soliciting business from the financial industry, creating an appearance of impropriety so blatant it undermines any confidence a consumer would have in the fairness of

NAF arbitration.

Similarly, as set forth in the Statement of Facts, NAF advertises to corporate counsel that it has a Loser Pays Rule for attorneys' fees. Applying a Loser Pays Rule undermines remedial statutes, such as those aimed at protecting consumers and the civil rights of workers. *See Christiansburg Garment Co. v. EEOC* , 434 U.S. 412, 418 (1978) . One state Supreme Court has held that a similar Loser Pays Rule in an arbitration agreement rendered the agreement substantively unconscionable. *See Sosa v. Paulos*, 924 P.2d 357, 362 (Utah 1996) (an arbitration provision requiring a medical malpractice plaintiff to pay the litigation costs of the doctor if the patient "wins less than half the amount of damages sought in arbitration" was unconscionable).

Check N Go can certainly produce a number of cases where courts have said positive things about the NAF. Unlike this case, however, none of the handful of cases in which courts have approved arbitration clauses forcing consumers to take their claims to the NAF or even in the few cases where courts have praised the NAF have the factual records that remotely compare to this one. None of these cases make reference to documents establishing that NAF made inappropriate promises to lenders, NAF made false and self-serving statements to courts, NAF ruled for lenders in 99.6% of cases, or to any of the other pieces of evidence in the record here. Simply put, the conclusions reached by other courts based upon records bereft of the powerful undisputed evidence present in this case are unpersuasive.

CONCLUSION

For the foregoing reasons, the Court should deny Check 'N Go's motion to compel individual arbitrations.

Respectfully submitted, this the 8th day of August, 2005.

F. Paul Bland, Jr.
F. Paul Bland, Jr. (Admitted pro hac vice)
Trial Lawyers for Public Justice
1717 Massachusetts Avenue, NW
Suite 800
Washington, D.C. 20036
Phone: 202-797-8600

Carlene McNulty
Carlene McNulty, N.C. State Bar No. 12488
North Carolina Justice Center
P.O. Box 28068
Raleigh, NC 27611
Phone: 919/856-2161

J. Jerome Hartzell, N.C. State Bar No. 7775
Hartzell & Whiteman, L.L.P.
2626 Glenwood Ave., Suite 500
Raleigh, North Carolina 27608
Phone: 919/571-8300

Mona Lisa Wallace, N.C. State Bar No. 9021
John Hughes, N.C. State Bar No. 22126
Wallace & Graham, P.A.
525 N. Main Street
Salisbury, NC 28144
Phone: 704/633-5244

Mallam J. Maynard, N.C. State Bar No. 10999
Financial Protection Law Center
P.O. Box 390
Wilmington, NC 28402
Phone: 910/442-1010

Richard A. Fisher (pro hac vice)
1510 Stuart Rd., N.E., Suite 210
Cleveland, TN 37312
Phone: 423/479-7009

Stephen Gardner (pro hac vice)
Law Office of Stephen Gardner, PC
6060 North Central Expressway, Suite 560
Dallas, TX 75206
Phone: 214/800-2830