

No. S113725

IN THE SUPREME COURT OF CALIFORNIA

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DISCOVER BANK,

Petitioner,

v.

THE SUPERIOR COURT OF LOS ANGELES COUNTY,

Respondent;

CHRISTOPHER BOEHR,

Real Party in Interest.

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After an Order by the Court of Appeal, Second Appellate District, Case No. B161305, Granting Petition for a Writ of Mandate from the Order of the Superior Court of Los Angeles County, Case No. BC256167, Granting a Motion for Reconsideration, The Honorable Carolyn Kuhl

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**OPENING BRIEF ON THE MERITS**

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## **STATEMENT OF ISSUES**

1. Is a provision in a non-negotiable arbitration clause in a consumer contract that prohibits consumers from bringing or participating in a class action conscionable and enforceable as a matter of California contract law? (No.)
2. If a type of provision in an adhesion contract is unconscionable under the California law of contracts that is generally applicable to all contracts, does the Federal Arbitration Act preempt this California contract law if such a provision is included in a contract that also contains an arbitration clause? (No.)

## **STATEMENT OF THE CASE**

Plaintiff Christopher Boehr obtained a credit card from defendant Discover Bank in 1986. In July of 1999, Discover unilaterally added an arbitration clause to the cardholder agreements of its customers. The clause states, in part:

NEITHER YOU NOR WE SHALL BE ENTITLED TO JOIN OR CONSOLIDATE CLAIMS IN ARBITRATION BY OR AGAINST OTHER CARD MEMBERS WITH RESPECT TO OTHER ACCOUNTS, OR ARBITRATE ANY CLAIM AS A REPRESENTATIVE OR MEMBER OF A CLASS OR IN A PRIVATE ATTORNEY GENERAL CAPACITY.

On August 15, 2001, plaintiff filed this putative class action. The complaint alleged that Discover improperly failed to credit payments from cardholders on the day received, if such payments were received after 1:00 p.m. As a result of this policy, Discover allegedly imposed late fees of approximately \$29 on payments that it received after 1:00 p.m. even when the payment was received on the date that the consumer had been told it was due. Additionally, any customer who maintained a balance was charged interest for the date on which payment was actually received, if the payment was received after 1:00 p.m. Plaintiff believes that the claims of

most individual putative class members are well below \$100, and many are under \$1.00 individually, although they amount to millions of dollars in the aggregate.

The trial court initially granted Discover's motion to compel arbitration. The trial court questioned whether Discover's unilateral amendment would form a binding contract under California law. Nonetheless, the trial court held that Delaware law governed the issue of contract formation and that a contract was formed under Delaware law.<sup>1</sup> The trial court rejected the plaintiff's challenge to the prohibition on class actions, stating that "[t]here does not appear to be a California appellate authority holding that a contract clause precluding one party from bringing a class action is unconscionable." Accordingly, the trial court compelled plaintiff to arbitrate the case on an individual basis.

Shortly after that order was entered, the Fourth District Court of Appeal issued its decision in *Szetela v. Discover Bank* (2002) 97 Cal. App. 4<sup>th</sup> 1094, 118 Cal.Rptr.2d 862, *cert. denied* (2003) 123 S.Ct. 1258 ("*Szetela*"), holding that it was unconscionable for a corporation to use an adhesive arbitration clause – the same clause that is at issue here – to prohibit class actions. After considering the *Szetela* decision, the trial court reversed itself and held that the identical provision barring class actions was unconscionable and unenforceable. The trial court did not strike the entire arbitration clause, however. Instead, the trial court severed the class action ban from the rest of the arbitration clause, and compelled plaintiff to arbitrate his claims.

Discover chose not to risk the possibility of class-wide arbitration of

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<sup>1</sup> Plaintiff-Petitioner disagrees with the Court of Appeal's reasoning on this point, but has not pursued that question in this appeal in an effort to narrow the issues.

this case before the arbitration firm it selected, however. Instead, Discover appealed the trial court's order to the Court of Appeal for the Second District. That Court of Appeal issued its opinion on January 14, 2003. The opinion conflicts with the well thought out and oft-cited *Szetela* decision, and reverses the trial court's order striking the class action ban, thereby requiring plaintiff to pursue his claims in arbitration on an individual basis.

The Court of Appeal's opinion below recognizes that the Federal Arbitration Act ("FAA") "places arbitration agreements on an equal footing with contracts generally." 105 Cal. App.4th 326, 328, 129 Cal.Rptr.2d 393, 401. The Court below also noted that another California Court of Appeal had refused to enforce a choice of law provision that barred California consumers with small claims from proceeding on a class action basis, in a case where the choice-of-law provision was not contained in an arbitration clause. 105 Cal. App.4th at 340, 129 Cal.Rptr.2d at 403, citing *America Online, Inc. v. Superior Court* (2001) 90 Cal. App. 4<sup>th</sup> 1, 108 Cal.Rptr.2d 699 ("*AOL*"). The court below nonetheless stated that *AOL* did not apply here because that case did not involve an arbitration agreement or the FAA. 105 Cal. App.4th at 341, 129 Cal.Rptr.2d at 404. The court below ultimately concluded that, whatever California law might be for bans on class actions in contracts in general, the FAA preempted the application of this state law to arbitration clauses.

The Court of Appeal recognized that the primary purpose of the FAA "was to reverse the longstanding judicial hostility to arbitration agreements. . . ." 105 Cal. App. 4<sup>th</sup> at 332, 129 Cal.Rptr.2d at 401 (citation omitted). Nevertheless, the Court proceeded to prohibit the possibility that the plaintiffs' class-wide claims could be arbitrated because of its concerns that "a multi-million dollar class arbitration award entered on nothing more than mere whim cannot be corrected under California law." 105 Cal. App.

4<sup>th</sup> at 348, 129 Cal.Rptr.2d at 410. With this openly hostile view of the arbitration process in mind, the court below concluded that “we disagree with the *Szetela* decision and grant Discover Bank’s petition.” 105 Cal. App. 4<sup>th</sup> at 331, 129 Cal.Rptr.2d at 396. Finally, the Court of Appeal held that the FAA “preempts a state court’s ability to invalidate on state substantive law grounds the express terms of a validly formed arbitration agreement. . . .” *Id.*

### SUMMARY OF ARGUMENT

California law governs the question of whether the terms of a contract of adhesion entered into in California by California consumers is enforceable. Discover argued that this Court never should have granted review, because a choice-of-law clause specifying Delaware law governs here. However, under California’s choice of law rules, that term cannot be applied to the contract’s ban on class actions if applying Delaware law would cause “substantial injustice.” *See Washington Mutual Bank v. Superior Court* (2001) 24 Cal.4th 906, 103 Cal. Rptr.2d 320 (“*Washington Mutual*”). If the application of Delaware law on this point would require California consumers and consumers suing in California with modest claims to lose their only meaningful opportunity to obtain a remedy for an unfair or deceptive business practice, then this result would cause “substantial injustice” to the consumers and cannot be enforced.

Accordingly, the Delaware law issue is a red herring, and the real question is whether Discover’s ban on class actions is unconscionable under California law. This Court should make clear that a provision in an adhesion contract barring consumers or other individuals with little bargaining power from bringing modest claims on a class action basis is unconscionable and unenforceable. As this Court explained in *Keating v.*

*Superior Court*, (1982) 31 Cal.3d 584, 183 Cal.Rptr. 360, *rev'd on other grounds sub nom., Southland Corp. v. Keating* (1984) 465 U.S. 1, contractual provisions banning class actions “effectively foreclos[e] many individual claims,” and thus “may well be oppressive and may defeat the expectations of the nondrafting party.” *Keating*, 31 Cal.3d at 608, 183 Cal.Rptr. at 375.

There are at least two different bases for this rule. First, a contractual ban on class actions is unconscionable as applied to claims of modest size because it effectively serves as an illegal exculpatory clause. Second, a ban on class actions in an adhesive consumer contract such as the one at issue here is unconscionable because it is one-sided and effectively non-mutual – that is, it benefits only the corporate defendant, and could never operate to the benefit of the consumer.

The Court of Appeal’s decision below held that even if the provision in Discover’s contract banning class actions was unconscionable under California law, that California law in this respect is preempted by the FAA. The Court below went so far as to hold that California’s generally applicable law of unconscionability is preempted by the FAA whenever that law strikes down “the express terms of a validly formed arbitration agreement.” 105 Cal. App.4th at 338, 129 Cal.Rptr.2d at 395. The Court of Appeal’s conclusion on this point is plainly wrong.

First, § 2 of the FAA provides that courts should not enforce arbitration clauses that run afoul of generally applicable state contract law, such as California’s proscription of unconscionable contract terms. California’s prohibition on exculpatory clauses in contracts of adhesion is a generally applicable body of law, as is evidenced by the fact that California courts have refused to enforce contractual bans on class actions in cases that have nothing to do with arbitration clauses. *See, e.g., AOL*, 90 Cal. App.

4th 1, 108 Cal.Rptr.2d 699. The decision of the Court of Appeal in this case is that even if a contractual ban on class actions is illegal under generally applicable California contract law, the FAA requires that such a ban nonetheless be enforced if it is included in an arbitration clause. As the FAA itself and the U.S. Supreme Court have made clear, the FAA incorporates – rather than sweeps away – such generally applicable state laws.

The absolutist reasoning of the Court below is also flatly contrary to several rulings of this Court and many other courts that arbitration clauses whose “express terms” are particularly unfair or one-sided are unconscionable and thus unenforceable. *E.g., Armendariz v. Foundation Health Psychare Serv.s, Inc.* (2000) 24 Cal. 4<sup>th</sup> 83, 99 Cal.Rptr.2d 745 (striking down as unconscionable an arbitration clause whose “express terms” were one-sided and imposed excessive costs on an employee); *Graham v. Scissor-Tail, Inc.* (1981) 28 Cal. 3d 807, 171 Cal.Rptr. 604 (striking down as unconscionable an arbitration clause whose “express terms” rendered the arbitrator presumptively biased in favor of one party).

Secondly, the U.S. Supreme Court has instructed that, under the FAA, arbitration clauses are only enforceable to the extent that they permit parties to effectively enforce their substantive rights. Accordingly, where (as here) the plaintiffs’ claims are so small that the vast majority of persons will not be able to vindicate those claims on an individual basis (whether in court or in arbitration), then prohibiting arbitration clauses which would ban class actions and thereby prevent the enforcement of statutory rights is entirely consistent with the FAA.

## **ARGUMENT**

### **I. DISCOVER’S CONTRACT TERMS CANNOT BE**

**ENFORCED IF THEY ARE UNCONSCIONABLE UNDER CALIFORNIA LAW.**

Discover has argued that this Court should not have granted review in this case because it does not matter whether its arbitration clause is unconscionable under California law, as the contract contains a choice of law provision stating that the contract is governed by Delaware law. Therefore, according to Discover, California law only applies to the choice of law provision, and not to the rest of the contract. Discover's premise is that Delaware law is so favorable to banks that it would find almost nothing in a bank contract unconscionable.<sup>2</sup>

The proper application of Delaware law is not one of the two questions on which this Court granted review. Both questions (which are set forth at page 1, *supra*) focus on California law. In anticipation that Discover will continue to argue that it can use Delaware law to strip consumers of meaningful remedies, this brief will begin with the choice-of-law issue. If Discover is correct that Delaware law would permit a contract of adhesion to ban all class actions, then this Court should apply California

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<sup>2</sup> In fact, Delaware courts – like this Court – have struck down abusive and excessively unfair arbitration clauses as unconscionable. *Worldwide Inc. Group v. Klopp* (Del. 1992) 603 A.2d 788. Nonetheless, Delaware law of unconscionability is much less mature and developed than California law, and Delaware is unclear as to the conscionability of contract provisions banning class actions in contracts of adhesion. There is one Delaware lower court decision stating that a contractual ban on class actions is not unconscionable, but that decision offers no explanation and is purely conclusory. The Court of Appeal below relied upon one federal case that did not involve state law unconscionability issues, or the application of the FAA to such law, but instead addressed questions of interpretation of a federal statute not involved here. *Johnson v. W. Suburban Bank* (3d Cir. 2000) 225 F.3d 366, *cert. denied*, 531 U.S. 1145 (2001), cited by the Court below at 105 Cal. App. 4<sup>th</sup> at 334. The *Johnson* case revolved around the language and legislative history of the Truth in Lending Act. That case says nothing about what Delaware or California state law may or may not be with respect to exculpatory clauses.

law rather than Delaware law to the question of the unconscionability of the contractual ban on class actions included in Discover's arbitration clause – for the simple reason that if Discover is right about Delaware law on this point, the application of that law would cause substantial injustice to California consumers and consumers suing in California. *See Washington Mutual Bank v. Superior Court* (2001) 24 Cal.4th 906, 918, 103 Cal.Rptr.2d 320, 330 (“*Washington Mutual*”) (“Of course, choice-of-law agreements have no effect . . . if the trial court determines that they are unenforceable . . .”).

This Court has indicated that in a contracting situation between two sophisticated, commercial bargainers, a choice of law clause is usually enforced under California law unless 1) the chosen state has no substantial relationship to the parties or their transaction; or 2) the chosen state's law is contrary to a fundamental policy of California, and California has a materially greater interest than the chosen state in the determination of that particular issue. *Nedlloyd Lines B.V. v. Superior Court* (1992) 3 Cal.4th 459, 465, 11 Cal.Rptr.2d 330, 333, quoting the Restatement (Second) of Conflict of Laws § 187. However, where the contract is one of adhesion, presented to the weaker party on a take-it-or-leave-it basis, this Court has followed the Restatement in providing “safeguards to protect contracting parties . . . against choice of law agreements that are unreasonable or in contravention of a fundamental California policy.” *Washington Mutual*, 24 Cal.4th at 917, 103 Cal.Rptr.2d at 329. These safeguards include the rule that “the weaker party to an adhesion contract may seek to avoid enforcement of a choice-of-law provision therein by establishing that ‘substantial injustice’ would result from its enforcement or that superior power was unfairly used in imposing the contract.” *Washington Mutual*, 24 Cal.4th at 918, 103 Cal.Rptr.2d at 329 (citations omitted). The legal



prohibition on “substantially unjust” choice-of-law provisions is essentially just an application of the normal contract law against unconscionable contract terms.

The roots of the “substantial injustice” rule for choice-of-law clauses are reflected in comment b of the Restatement:

A choice-of-law provision, *like any other contractual provision*, will not be given effect if the consent of one of the parties to its inclusion in the contract was obtained by improper means, such as by misrepresentation, duress, or undue influence, or by mistake. Whether such consent was in fact obtained by improper means or by mistake will be determined by the forum in accordance with its own legal principles. A factor which the forum may consider is whether the choice-of-law provision is contained in an "adhesion" contract, namely one that is drafted unilaterally by the dominant party and then presented on a "take-it-or-leave-it" basis to the weaker party who has no real opportunity to bargain about its terms. Such contracts are usually prepared in printed form, and frequently at least some of their provisions are in extremely small print. Common examples are tickets of various kinds and insurance policies. Choice-of-law provisions contained in such contracts are usually respected. Nevertheless, the forum will scrutinize such contracts with care and *will refuse to apply any choice-of-law provision they may contain if to do so would result in substantial injustice to the adherent*.

Restatement (Second) of Conflict of Laws § 187, comment b (1971)  
(emphasis added).<sup>3</sup>

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<sup>3</sup> One illustration to the Restatement further establishes that the protections against unjust choice-of-law clauses apply with particular strength in settings like this case, that involve contracts of adhesion. The Restatement provides the following scenario: A buys a steamship ticket in state X for transportation to state Y. The ticket contains a choice of law provision stating that it is governed by the laws of state Y, and also that the steamship company will not be liable for injuries resulting from the negligence of its servants. Such a provision is valid under Y’s law, but invalid under X’s law. In determining whether to give effect to this contract, the Restatement says, the court must give consideration to the fact that  
(continued...)

Given that the “substantial injustice” analysis follows other similar contract fairness tests, such as unconscionability, it should be applied to each part of the choice of law clause. *See Application Group, Inc. v. Hunter Group, Inc.* (1998) 61 Cal. App.4th 881, 896, 72 Cal. Rptr.2d 73 (“A separate choice of law inquiry must be made with respect to each issue in a case.”) Put another way, the effect of the chosen forum on each aspect of the parties’ rights should be examined to see if there are only isolated incidents of unfairness, or whether the entire choice of law clause must be stricken from the contract. *See, e.g., Armendariz*, 24 Cal.4th at 124, 99 Cal.Rptr.2d at 775 (holding, in the context of unconscionability, that courts must look to “the various purposes of the contract” to determine if the “tainted” sections “can be extirpated . . . by means of severance or restriction,” or whether they permeate the entire contract such that it cannot be enforced).

In a case similar to this one, a Court of Appeal concluded that “substantial injustice” resulted when the imposition of a choice of law clause, contained in an adhesion contract, had the effect of taking away plaintiffs’ right to bring a consumer claim as a class action. *AOL*, 90 Cal. App. 4<sup>th</sup> 1, 108 Cal.Rptr.2d 699. There, the Court considered a contract between AOL and its customers that included a choice of law and forum selection clause that had the effect of barring the customers from bringing consumer class actions. 90 Cal. App. 4<sup>th</sup> at 17, 108 Cal.Rptr.2d at 711. The Court determined that customers’ rights “would be substantially diminished if they [were] required to litigate their dispute in Virginia,

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<sup>3</sup> (...continued)

the contract was drafted unilaterally by the dominant party. Restatement (Second) of Conflict of Laws § 187, Illustration 3.

thereby violating an important public policy underlying California's consumer protection law.” 90 Cal. App. 4<sup>th</sup> at 5, 108 Cal.Rptr.2d at 702. In such a case, “California courts will refuse to defer to the selected forum.” 90 Cal. App. 4<sup>th</sup> at 12, 108 Cal.Rptr.2d at 708.<sup>4</sup>

The case at bar is strikingly similar. Here, too, customers are faced with a choice of law clause, presented on a take-it-or-leave-it basis, that effectively takes away any opportunity to vindicate important substantive rights under California law. In this case, that right is the opportunity for any meaningful remedy for claims such as breach of an unfair or deceptive acts or practices act (UDAP). As we will argue in more detail below, California courts have made it clear that the right to bring consumer claims on a class action basis is a key part of this state’s substantive law of consumer protection. To the extent that Delaware law would not similarly find a class action ban which denied consumers any effective enforcement of their statutory rights to be unconscionable, then the choice of Delaware law would leave all or nearly all of Discover’s consumers without any effective remedy. Accordingly, the choice of Delaware law cannot be enforced.

Plaintiff does not claim that all Delaware law is ineffective and unfair. Indeed, outside of the question as to whether Delaware law permits contracts of adhesion to waive a consumer’s right to participate in or bring a class action, plaintiff knows of no other grounds to disregard Delaware’s general unfair and deceptive acts and practices statute. Accordingly,

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<sup>4</sup> Contrary to Discover’s assertions in its Answer to Petition for Review, the Court of Appeal in *AOL* rested its decision not only on the fact that the Consumer Legal Remedies Act gives plaintiffs a right to bring class actions, but also, and independently, on California’s general policy in favor of the right to class action relief in consumer cases. *AOL*, 90 Cal. App. 4<sup>th</sup> at 5, 108 Cal.Rptr.2d at 702; *see also* discussion at *infra* III(C).

plaintiff has not argued that Delaware law should be displaced in its entirety. Neither party has suggested that the remaining substantive terms of the Delaware consumer protection laws are inadequate, or would cause substantial injustice if applied to this case. Thus, the choice of law clause should be struck only so far as it causes substantial injustice – that is, only so far as it limits the ability of California consumers or consumers bringing cases in California to bring their claims as a class action, which in this state is an important part of *any* UDAP claim. Because that limitation violates an important California public policy, it must not be enforced by this Court in this case. Hence, this Court need look only at California law when examining the argument that Discover’s ban on class actions is unconscionable.

**II UNDER GENERALLY APPLICABLE CALIFORNIA CONTRACT LAW, A PROVISION IN A CONTRACT OF ADHESION THAT PROHIBITS CLASS ACTIONS IS UNCONSCIONABLE.**

This Court should make clear that Discover’s ban on class actions would have been unconscionable under generally applicable California contract law if it were not incorporated into an arbitration agreement. Once this conclusion is established, then the only question becomes whether the court below is correct that the FAA overrides this contract law when the provision is incorporated into an arbitration agreement.

Under generally applicable California contract law, unconscionability has both a “procedural” and a “substantive” element. Both the procedural and substantive elements must be present before a court will hold that a contract is unenforceable, but they need not be present to the same degree. *See Armendariz*, 24 Cal.4th at 114, 99 Cal.Rptr.2d at 767-68. Instead, there is a sliding scale relationship between the two concepts:

“the more substantively oppressive the contract term, the less evidence of procedural unconscionability is required to come to the conclusion that the term is unenforceable, and vice versa.” *Id.*

**A. Discover’s Arbitration Clause Is Procedurally Unconscionable.**

There is no question here that Discover’s arbitration clause is procedurally unconscionable. Under California law, if a contract is one of adhesion, it is procedurally unconscionable. As this Court explained in the recent case of *Little v. Auto Stiegler, Inc.* (2003) 29 Cal.4th 1064, 1071, 130 Cal. Rptr.2d 892, 897:

The procedural element of an unconscionable contract generally takes the form of a contract of adhesion, ‘which, imposed and drafted by the party of superior bargaining strength, relegates to the subscribing party only the opportunity to adhere to the contract or reject it.’

(quoting *Armendariz*, 24 Cal.4th at 114, 99 Cal. Rptr.2d at 745.) *See also Circuit City v. Adams* (9th Cir.) 279 F.3d 889, 893, *cert. denied*, (2002) 535 U.S. 1112 (a contract is procedurally unconscionable if it is “a contract of adhesion: a standard-form contract, drafted by the party with superior bargaining power, which relegates to the other party the option of either adhering to its terms without modification or rejecting the contract entirely.”); *Flores v. Transamerica Homefirst, Inc.* 93 Cal. App. 4th 846, 853, 113 Cal.Rptr.2d 376, 381-82 (same); *Mercuro v. Superior Court* (2002) 96 Cal. App. 4th 167, 174, 116 Cal.Rptr.2d 671, 676 (same).

In this case, it is undisputed that Discover’s arbitration clause was a standard form contract drafted by Discover, the party with superior bargaining power, and unilaterally promulgated to the consumers on a take-it-or-leave-it adhesive basis. The unilateral amendment containing the arbitration clause was communicated to Discover’s customers as an insert to

their bill (a so-called “bill stuffer”) that few customers would ever read or notice. This is a classic contract of adhesion, and is thus procedurally unconscionable.

**B. Discover’s Contractual Ban on Class Actions is Substantively Unconscionable Because It Effectively Serves as an Exculpatory Clause.**

As this Court noted in the *Little* case, California law does not permit contracts of adhesion to impose exculpatory clauses upon parties that would cause those parties to lose public rights. “One such long-standing ground for refusing to enforce a contractual term is that it would force a party to forego unwaivable public rights . . . .” *Little*, 29 Cal.4th at 1078, 130 Cal. Rptr.2d at 904, citing *Baker Pacific Corp. v. Suttles* (1990) 220 Cal. App.3d 1148, 1153-1154, 269 Cal. Rptr. 709 (mandatory employee waiver of all employer liability for asbestos exposure contrary to public policy). This Court went on to explain “We note that the prohibition against exculpatory contracts contrary to public policy is generally invoked in the context of contracts of adhesion. (See, e.g., *Baker Pacific Corp. v. Suttles*, supra, 220 Cal. App.3d at p. 1151, 269 Cal. Rptr. 709; *Tunkl v. Regents of University of California* (1963) 60 Cal.2d 92, 99-100, 32 Cal. Rptr. 33, 383 P.2d 441.)” *Little*, 29 Cal.4th at 1078 n.2, 130 Cal. Rptr.2d at 904. In *Armendariz*, similarly, this Court made clear that parties with superior bargaining power may not impose exculpatory clauses upon others in adhesion contracts: “It is indisputable that an employment contract that required employees to waive their rights under the FEHA to redress sexual harassment or discrimination would be contrary to public policy and unenforceable.” 24 Cal.4th at 100-01, 99 Cal. Rptr.2d at 757-58.

In addition, it is clear that the prohibition on exculpatory clauses in contracts of adhesion applies not only to contract terms that explicitly strip

parties of public rights, but also apply to contract terms that *effectively* strip parties of their public rights. It would make no sense to say that a party could not write a contract that explicitly says “you may not bring an action under any state consumer protection law,” but to permit the same party to write a contract that requires the use of procedures that would make it effectively impossible for parties to bring an action under state consumer protection laws.

As *Little* and *Armendariz* make clear, this generally applicable policy against exculpatory clauses for claims involving public rights applies with equal force to arbitration agreements:

[A]rbitration cannot be misused to accomplish a de facto waiver of these rights. Accordingly, although the *Armendariz* requirements specifically concern arbitration agreements, they do not do so out of a generalized mistrust of arbitration per se (see *Doctor’s Associates, Inc.*, *supra*, 517 U.S. at p. 687, 116 S.Ct. 1652), but from a recognition that some arbitration agreements and proceedings may harbor terms, conditions and practices that undermine the vindication of unwaivable rights. The *Armendariz* requirements are therefore applications of general state law contract principles regarding the unwaivability of public rights to the unique context of arbitration, and accordingly are not preempted by the FAA. And, as discussed above, there is no reason under *Armendariz*’s logic to distinguish between unwaivable statutory rights and unwaivable terms derived from common law.

*Little*, 29 Cal.4th at 1079, 130 Cal. Rptr.2d at 904.

In a discussion that anticipates the later exposition of this principle relating to exculpatory clauses, this Court explained in *Keating* how a contractual ban on class actions is substantively unconscionable as applied to persons with individually modest claims. In *Keating*, this Court held that clauses banning class actions “may well be oppressive and may defeat the expectations of the nondrafting party.” *Keating*, 31 Cal.3d at 608, 183 Cal. Rptr. at 375. This Court went on to say that “[i]f the right to a classwide

proceeding could be automatically eliminated in relationships governed by adhesion contracts through the inclusion of a provision for arbitration, the potential . . . for chilling the effective protection of interests common to a group[] would be substantial.” 31 Cal.3d at 609, 183 Cal. Rptr. 360 at 375.

This generally applicable law is what animated the Court of Appeal in *Szetela*. In that case, the Court examined Discover Bank’s no-class-actions arbitration clause and correctly explained that allowing such contractual prohibitions on class actions would effectively act 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.

The Ninth Circuit, applying California law and armed with a rich factual record, expanded even further on this phenomenon. In *Ting v. AT&T* (9<sup>th</sup> Cir. 2003) 319 F.3d 1126, the Ninth Circuit found that AT&T’s prohibition on class actions was one-sided and non-mutual. Based upon extensive proof and testimony at the trial, the district court had also found, however, that the ban on class actions effectively would operate as an exculpatory clause. The district court found that the evidence in that case established that before AT&T had adopted its arbitration clause, consumers



had successfully prosecuted a number of class actions against long distance phone carriers. *Ting v. AT&T* (N.D. Cal. 2002) 182 F. Supp.2d 902, 915. In one case, AT&T paid 100% of the class members' damages, *id.* at 918, and in another case a class recovered \$88 million from another long distance carrier. *Id.* The parties in *Ting* stipulated that none of the lawyers in any of the identified earlier class actions could have brought those cases on an individual basis, whether in court or arbitration. *Id.* Based on these and other facts, 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 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 district court in *Ting* found the ban on class actions in AT&T's arbitration clause to be substantively unconscionable. *Id.* at 931.

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.").

Indeed, some corporate defense counsel have openly urged corporate defendants to "defend themselves" against class actions through use of

mandatory arbitration. As one defense lawyer has written, “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). 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).

Discover has suggested that class action bans are never unconscionable because the class action is merely a procedural device, and arbitration clauses may enact any procedures imaginable without being unconscionable. Discover’s theory is plainly incorrect, however, under this Court’s own teachings. Rules regarding filing fees and other forum costs of arbitration are clearly procedural, not substantive, in nature. Under this theory, therefore, an arbitration clause could impose enormous fees against a consumer and yet remain immune from any state laws relating to unconscionability. As this Court recognized in *Little*, however, “[s]ome arbitration agreements and *proceedings* may harbor terms, conditions and *practices* that undermine the vindication of unwaivable rights.” 29 Cal. 4<sup>th</sup> at 1079, 130 Cal. Rptr.2d at 904 (first italics in original, second two italics

added). The U.S. Supreme Court has recognized, similarly, that “the existence of large arbitration costs may well preclude a litigant . . . from effectively vindicating [its] rights.” *Green Tree Financial Corp. v. Randolph* (2000) 531 U.S. 79, 81. If a procedural device (such as a contractual class action ban) would in some cases “effectively” bar individuals from vindicating their substantive rights, and thus would have the same impact as a more direct exculpatory clause, the procedural quality of this contract provision does not save it from violating state laws relating to unconscionable contracts. If every contract term labeled “procedural” were beyond the reach of state law, the drafters of adhesive contracts could easily evade limits on exculpatory clauses by requiring persons with small claims to travel to a completely inaccessible forum (perhaps an uninhabited part of New Zealand) to arbitrate claims.

**C. Discover’s Contractual Ban on Class Actions is Substantively Unconscionable Because It Is One-Sided and Effectively Non-Mutual.**

The law is clear in California that parties with superior bargaining power may not impose one-sided, non-mutual arbitration clauses upon weaker parties. In the setting of employment contracts, this Court stated:

We conclude, rather, that in the context of an arbitration agreement imposed by the employer on the employee, such a one-sided term is unconscionable. Although parties are free to contract for asymmetrical remedies and arbitration clauses of varying scope, *Stirlen* [*v. Supercuts, Inc.* (1997) 51 Cal. App. 4<sup>th</sup> 1519, 60 Cal. Rptr.2d 138] and *Kenny* [*v. United Health Care Services, Inc.* (1999) 70 Cal. App. 4<sup>th</sup> 1322, 83 Cal. Rptr.2d 348] are correct that the doctrine of unconscionability limits the extent to which a stronger party may, through a contract of adhesion, impose the arbitration forum on the weaker party without accepting that forum for itself.

*Armendariz*, 24 Cal.4th at 100-01, 99 Cal. Rptr.2d at 770.

This Court reaffirmed this principal in *Little*, and extended it to the setting of an arbitration clause that provided for a one-sided right to appeal arbitral awards of over \$50,000. *Little*, 29 Cal.4th at 1073, 130 Cal. Rptr.2d at 899 (“Given the fact that Auto Stiegler was the party imposing the arbitration agreement and the \$50,000 threshold, it is reasonable to conclude it imposed the threshold with the knowledge or belief that it would generally be the defendant [who benefits from the threshold].”).

A number of courts have applied this rule about one-sided contracts to consumer contracts. In *Flores v. Transamerica Homefirst, Inc.* (2001) 93 Cal. App. 4<sup>th</sup> 846, 113 Cal. Rptr.2d 376, an arbitration clause in a “reverse mortgage” loan bound borrowers for all claims, but exempted the lender’s claims involving foreclosure, self-help remedies and receivership. The court found that “[a]s a practical matter, by reserving to itself the remedy of foreclosure, Homefirst has assured the availability of the only remedy it is likely to need,” that “Homefirst has attempted to maximize its advantage by avoiding arbitration of its own claims,” and that the arbitration clause was therefore unconscionable absent a justification for this advantage. *See also ACORN v. Household Int’l, Inc.* (N.D. Cal. 2002) 211 F. Supp.2d 1160, 1173 (arbitration clause in home equity loan is unconscionable in part based on exclusion of lender’s foreclosure remedies); *Luna v. Household Finance Corp. III* (W.D. Wash. 2002) 236 F.Supp.2d 1166 (same, applying Washington contract law); *Iwen v. U.S. West Direct* (Mont. 1999) 977 P.2d 989 (arbitration clause binding telephone company’s advertising customers but not its own customers unconscionable); *State ex rel Dunlap v. Berger*, 567 S.E.2d 265, 280 n. 12 (“*Dunlap*”) (arbitration clause’s reservation of retailer’s judicial collection and repossession actions provides adequate grounds for finding clause substantively unconscionable).

In this case, it is abundantly clear that Discover’s contractual ban on

class actions will benefit only Discover. This nearly self-evident fact was set out cogently by the Court of Appeals in *Szetela*:

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, because credit card companies typically do not sue their customers in class action lawsuits. This provision is clearly meant to prevent customers, such as *Szetela* and those he seeks to represent, from seeking redress for relatively small amounts of money, such as the \$29 sought by *Szetela*. Fully aware that few customers will go to the time and trouble of suing in small claims court, Discover has instead sought to create for itself virtual immunity from class or representative actions despite their potential merit, while suffering no similar detriment to its own rights.

*Szetela*, 97 Cal. App.4th at 1101, 118 Cal. Rptr. 2d at 867.

In *Ting*, similarly, the Ninth Circuit held that an identical term was one-sided and not bilateral because it limited the remedies available to consumers, but not AT&T. While a number of consumers have brought successful class actions against AT&T, the Ninth Circuit correctly observed that “[i]t is difficult to imagine AT&T bringing a class action against its own customers. . . .” *Ting*, 319 F.3d at 1150. Similarly, in *Luna* the court found that the arbitration clause worked an oppression against consumers because the class action ban was effectively one-sided in taking away remedy that only consumers would ever use. 236 F.Supp.2d at 1179.

The Ninth Circuit’s decision in *Ting* is a faithful application of this Court’s arbitration jurisprudence – a logical extension of *Armendariz* to facts that are indistinguishable from those at issue in this case. This Court should embrace and endorse its reasoning.

**III. THE FEDERAL ARBITRATION ACT DOES NOT PREEMPT THE GENERALLY APPLICABLE PRINCIPLE OF CALIFORNIA STATE LAW HOLDING BANS ON CLASS ACTIONS TO BE UNCONSCIONABLE.**

The Court below concluded that the FAA supposedly sweeps away California’s law of unconscionability as it relates to any “express provision” of any arbitration contract, including any provision that bans class actions. This claim is simply incorrect.

**A. There Is a Heavy Presumption Against Finding Federal Preemption of State 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. Particularly where “federal law is said to bar state action in fields of traditional state regulation, we have worked on the assumption that the historic police powers of the States were not to be superseded by the Federal Act unless that was the clear and manifest purpose of Congress.” *California Div. of Labor Standards Enforcement v. Dillingham Construction, N.A., Inc.* (1997) 519 U.S. 316, 325 (quoting *Rice v. Santa Fe Elevator Corp.* (1947) 331 U.S. 218, 230). California’s common law of contracts and unconscionability are an area of traditional and almost exclusive state regulation. *See, e.g., Erie Railroad Co. v. Tompkins* (1938) 304 U.S. 64, 78 (“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 where a federal statute does not preempt an entire field, state law will only be preempted if there is an “actual conflict” between federal and state law, 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* (1995) 514 U.S. 280, 287 (citations omitted). This standard is not easily met, and, in particular, there cannot be implied conflict preemption where there is no federal law standard addressing the

subject of state law regulation.

In *Freightliner Corp.*, for example, the U.S. Supreme Court held that a state tort law standard of care calling for antilock brakes in 18-wheel tractor-trailers was not preempted by federal law because the only federal regulation that ever addressed the subject of antilock brakes on these vehicles had been repealed. *Freightliner Corp.*, 514 U.S. at 284-85. The Court held 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. Likewise, the Court held that there could be no frustration of federal purposes because “[a] finding of liability against petitioners would undermine no objectives or purposes with respect to ABS devices, since none exist.” *Id.* at 289-90; *see also Sprietsma v. Mercury Marine* (2002) 123 S. Ct. 518, 527-28 (finding no implied conflict preemption of common law tort claims in the absence of governing federal regulation).

**B. The FAA Only Preempts Those State Laws that Would Frustrate the Act, and It Contains An Explicit Savings Clause for Generally Applicable State Law.**

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.* (1989) 489 U.S. 468, 477. Therefore, the FAA only preempts state laws whose application would frustrate the will of Congress by undermining the Act’s policy goals. *Id.* at 477-78.<sup>5</sup>

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<sup>5</sup> The U.S. Supreme Court created the doctrine of FAA preemption in *Southland v. Keating* (1984) 465 U.S. 1. While the plaintiff/petitioner does not suggest that *Southland* is no longer good law, the sharp concerns expressed at various times by five of the sitting members of the U.S. Supreme Court counsel, at a minimum, (continued...)

In addition, the FAA incorporates a savings clause that 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 is available to a party challenging an arbitration agreement. *Doctor's Assocs., Inc. v. Casarotto* (1996) 517 U.S. 681, 687 (“[G]enerally applicable contract defenses, such as fraud, duress or unconscionability, may be applied to invalidate arbitration agreements without contravening [the F.A.A.]”).<sup>6</sup> In other words, state contract law applies to arbitration clauses. This principle is incorporated into the federal substantive law of arbitration. *Perry v. Thomas* (1987) 482 U.S. 483, 492-93 (“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

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<sup>5</sup> (...continued)

against any expansion here of the FAA’s preemptive scope. In *Southland*, Justices O’Connor and Rehnquist would have held that FAA § 2 does not apply in state court. 465 U.S. at 24 (O’Connor, J., joined by Rehnquist, J., dissenting). Justice Stevens in *Southland* would have found no preemption of the state law excluding wage claims from arbitration, 465 U.S. at 17-21 (concurring in part and dissenting in part), and in his dissent in *Perry*, he characterized *Southland* as having “rewritten the statute to give it a pre-emptive scope that Congress certainly did not intend,” 482 U.S. at 493 (Stevens, J., dissenting). *See, id.* at 494-495 (O’Connor, J. dissenting). In *Allied-Bruce*, Justices Scalia and Thomas would have held that the FAA does not apply in state courts, 513 U.S. at 284 (Scalia, J., dissenting); *id.* at 285-97 (Thomas, J., joined by Scalia, J., dissenting), whereas Justice O’Connor acquiesced on *stare decisis* grounds in the majority’s decision to uphold *Southland* even while she thought it was “wrong” and “continue[d] to believe that Congress never intended the Federal Arbitration Act to apply in state courts,” 513 U.S. at 283 (O’Connor, J., concurring).

<sup>6</sup> *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.”).



cover issues concerning the validity, revocability, and enforceability of contracts generally.”) [emphasis in original, citations omitted]. Likewise, this Court has also recognized that a court may refuse to enforce *any* facially valid contract on the ground that it is unconscionable. *Armendariz*, 24 Cal. 4<sup>th</sup> at 114, 99 Cal. Rptr.2d at 767 (“Because unconscionability is a reason for refusing to enforce contracts generally, it is also a valid reason for refusing to enforce an arbitration agreement.”).

**C. California’s Law of Unconscionability, As Applied to Contractual Bans on Class Actions, Is Generally Applicable State Law that Falls Within the FAA’s Savings Clause.**

California law preventing corporations from banning class actions in contracts of adhesion is a generally applicable rule of law. The rule that contracts of adhesion drafted by the party with superior economic power are procedurally unconscionable applies to all contracts, whether they include arbitration clauses or not.

In *AOL*, consumers sought to bring a class action against the internet company alleging claims under the Consumer Legal Remedies Act, and common law claims. AOL defended on the grounds that class actions were not permitted under its contract. AOL’s contract did not involve an arbitration clause, but instead included a forum-selection and choice-of-law clause that required consumers to bring any litigation in Virginia, whose procedural rules do not permit class actions. The Court of Appeal refused to enforce this unfair forum selection clause, which would have effectively barred all or nearly all of AOL’s consumers from any meaningful remedy, on generally applicable principles of California law:

“A class action by consumers produces several salutary byproducts, including a

therapeutic effect  
upon those sellers  
who indulge in  
fraudulent practices.  
...”

The unavailability of class action relief in this context is sufficient in and by itself to preclude enforcement of the TOS forum selection clause.

*AOL*, 90 Cal. App. 4<sup>th</sup> at 17-18, 108 Cal. Rptr. 2d at 712, quoting from *Vasquez v. Superior Court* (1971) 4 Cal.3d 800, 808, 94 Cal. Rptr. 796.

The *AOL* decision arose from a generally-applicable California public policy favoring class-wide relief as an important facet of consumer protection. This Court has held that “class actions offer consumers a means of recovery for most individual damages. . . .” *Linder v. Thrifty Oil Co.* (2000) 23 Cal.4th 429, 445, 97 Cal. Rptr. 2d 179, 191 (case not involving an arbitration clause). *Linder* followed the logic and reasoning established by this Court thirty years ago in *Vasquez*, 4 Cal.3d 800, 94 Cal. Rptr. 796, in which it considered the question of whether consumers could pursue a class action for restitution for fraud in connection with a now infamous scheme to sell freezers and a frozen meat plan to California customers under an installment purchase contract. The late Justice Mosk, writing for a unanimous Court, first noted that “[p]rotection of unwary consumers from being duped by unscrupulous sellers is an exigency of the utmost priority in contemporary society.” 4 Cal.3d at 808, 94 Cal. Rptr. at 800. The Court then explained the importance of class actions as an instrumentality of consumer protection in California.

Frequently, numerous consumers are exposed to the same dubious practice by the same seller so that proof of the prevalence of the practice as to one consumer would provide proof for all. Individual actions by each of the defrauded consumers is often impracticable because the amount of individual recovery would be insufficient to

justify bringing a separate action; thus an unscrupulous seller retains the benefits of its wrongful conduct.

*Id.*

Under this generally applicable principle of California law, it is recognized that if consumers with small claims are barred from pursuing class litigation, they will likely be denied any meaningful remedy for most wrongs that the company might commit against them. In short, "defendants should not profit from their wrongdoing simply because their conduct harmed large numbers of people in small amounts instead of small numbers of people in large amounts." *Linder*, 23 Cal.4th at 446, 97 Cal. Rptr. 2d at 192 (internal quote, citation omitted).

The principles set out in *Linder* and *Vasquez* are crucial here because, at bottom, this case is not really about arbitration but about the right to class action relief. If this Court reverses the decision of the Court of Appeal, Discover would still be able to hold its California customers to mandatory binding arbitration clauses if it so chooses. Indeed the trial court did not reject or deny arbitration, instead it ordered the plaintiffs to arbitrate their claims. If Discover wanted arbitration, it could have had it without bringing this appeal. The one thing that Discover could not have, however, whether in court or arbitration, was the ability to take away from customers the right to seek class-wide relief through class action proceedings (whether in arbitration or in court).

Notwithstanding the rhetoric of the Court below, applying the California rule prohibiting class action bans to contracts also providing for arbitration does not mean that corporations are barred from imposing arbitration on their consumers. No one denies that the drafter of any contract could both require arbitration *and* 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 does not violate the FAA.

**D. California’s Rule Against Exculpatory Clauses Is Entirely Consistent with the Supreme Court’s FAA Jurisprudence.**

As set forth above, California law may only be found to be preempted by the FAA if the state law conflicts with Congress’s purposes in enacting the FAA to such an extent that California law is an obstacle to the enforcement of federal law. In fact, California’s law prohibiting exculpatory clauses is entirely consistent with the purposes of the FAA, as the U.S. Supreme Court has articulated those purposes. The U.S. Supreme 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.* (1991) 500 U.S. 20, 26 (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 U.S. Supreme 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* (2000) 531 U.S. 79, 81. The U.S. Supreme Court has stated that arbitration is acceptable as an alternative to litigation in court because it is simply a “different forum” – one with somewhat different and simplified rules, but nonetheless one in which 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.* (2002) 534 U.S. 279, 295 n. 10.

California law recognizing the importance of class actions for

persons with small claims is also entirely consistent with the decisions of the U.S. Supreme Court on the point:

A significant benefit to claimants who choose to litigate their individual claims in a class-action context is the prospect of reducing their costs obligation, particularly attorney's fees, by allocating such costs among all members of the class who benefit from any recovery. Typically, the attorney's fees of a named plaintiff proceeding without reliance on Rule 23 could exceed the value of the individual judgment in favor of any one plaintiff. 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 proceeded on a contingent-fee basis.* This, of course, is a central concept of Rule 23.

*Deposit Guaranty Nat'l Bank v. Roper*, (1980) 445 U.S. 326, 338 n. 9 (emphasis added). *See also Amchem Products, Inc. v. Windsor* (1997) 521 U.S. 591, 617 ("The policy at the very core of the class action mechanism is to overcome the problem that small recoveries do not provide the incentive for any individual to bring a solo action prosecuting his or her rights. A class action solves this problem by aggregating the relatively paltry potential recoveries into something worth someone's (usually an attorney's) labor."); *Eisen v. Carlisle & Jacquelin* (1974) 417 U.S. 156, 161 (1974) ("A critical fact . . . is that petitioner's individual stake . . . is only \$70. No competent attorney would undertake this complex antitrust action to recover so inconsequential an amount. Economic reality dictates that petitioner's suit proceed as a class action or not at all.") This logic of this Court's decisions in cases such as *Linder* and *Vasquez* underlies cases such as *Szetela* and *Ting*, and the same roots are readily found in the federal law enunciated by the U.S. Supreme Court.

**E. The Absolutist Approach of the Court Below With Respect to FAA Preemption Conflicts With Numerous**

### **Decisions of This Court and Other Courts.**

The Court below concluded that California's generally applicable California contract law relating to exculpatory clauses is preempted, whenever it clashes with the "express terms" of an arbitration clause. This approach necessarily conflicts with numerous decisions of this Court, other courts applying California law, and other courts throughout the nation. The Court below asserts without reservation that the FAA "preempts a state court's ability to invalidate on state substantive law grounds the express terms of a validly formed arbitration agreement. . . ." 105 Cal. App.4th at 330, 129 Cal. Rptr. 2d at 395 Under this approach, no express term of an arbitration agreement may ever be held to be unconscionable. Numerous California Courts have struck down part or all of "validly formed arbitration agreements" where some of their "express terms" violated California's proscription against unconscionable contract terms. *See, e.g., Armendariz*, 24 Cal. 4<sup>th</sup> 83, 99 Cal. Rptr. 2d 745; *Graham*, 28 Cal.3d 807, 171 Cal. Rptr. 604; *Mercurio v. Superior Court* (2002) 96 Cal. App. 4<sup>th</sup> 167, 116 Cal. Rptr. 2d 671 (where arbitration clause's express terms required arbitration before a forum that was susceptible to repeat player bias, and clause required fee sharing by employees, it was unconscionable and unenforceable); *Flores*, 93 Cal. App. 4<sup>th</sup> 846, 113 Cal. Rptr.2d 376 (express terms of arbitration clause that was non-mutual was unconscionable and unenforceable); *Pinedo v. Premium Tobacco, Inc.* (2000) 85 Cal. App. 4<sup>th</sup> 774, 102 Cal. Rptr. 2d 435 (express terms of arbitration clause requiring an employee to front all fees in arbitration was unconscionable and unenforceable); *Stirlen v. Supercuts, Inc.* (1997) 51 Cal. App. 4<sup>th</sup> 1519, 60 Cal.Rptr. 2d 138 (express terms of arbitration clause that were one-sided were unconscionable); *Patterson v. ITT Consumer Fin. Corp.* (1993) 14 Cal. App. 4<sup>th</sup> 1659, 18 Cal. Rptr. 2d 563 (where arbitration clause's express terms required arbitration

in a prohibitively expensive forum, and in a forum that required consumers to travel to Minnesota to have their claims heard, the clause was unconscionable and unenforceable). If the logic and rationale of the Court of Appeal below were to be faithfully and consistently applied, it would be necessary to overturn each of these cases.

Numerous other courts have also held that particularly unfair or unconscionable 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 “We disagree with the California Court of Appeal’s recent analysis in *Discover Bank v. Superior Court*. . . . We recognize, as does the court in *Discover Bank*, 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.* (9<sup>th</sup> Cir. 2001) 265 F.3d 931, similarly, the defendant argued (as does the Court of Appeal in this case) 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.

A number of other courts have refused to enforce the express terms of arbitration clauses that were excessive. *See, e.g., Hooters of America, Inc. v. Phillips* (4<sup>th</sup> Cir. 1999) 173 F.3d 933, 940 (refusing to enforce arbitration clause that “entail[ed] procedures so wholly one-sided as to present a stacked deck”); *Floss v. Ryan’s Family Steak Houses, Inc.* (6<sup>th</sup> Cir. 2000) 211 F.3d 306 (refusing to enforce arbitration clause that gives

employer selected arbitrator “unfettered discretion in choosing the nature of that forum”); *Murray v. United Food and Commercial Workers Intnat’l Union* (4<sup>th</sup> Cir. 2002) (refusing to enforce arbitration clause whose terms gave one party the exclusive power to select the arbitrator); *Hudson v. Chicago Teachers Union Local No. 1* (7<sup>th</sup> Cir. 1984) (same).

**F. The Suggestion of the Court Below that Normal Rules of Contract Law May Not Be Applied to Arbitration Clauses Violates the U.S. Supreme Court’s Direction that Arbitration Clauses are to Be Placed On the “Same Footing” As Other Types of Contracts.**

The Court of Appeal’s decision itself contravenes the FAA by applying different legal standards to Discover’s arbitration clause than are applied to other contracts. The FAA’s goals are to “reverse the longstanding judicial hostility to arbitration agreements . . . and to place arbitration agreements *upon the same footing as other contracts.*” *EEOC v. Waffle House, Inc.* 534 U.S. at 289 (emphasis added, citation omitted).

Notwithstanding this law, the Court below did *not* put arbitration clauses on the same footing as other contracts. The Court of Appeal’s position amounts to the following: even if California’s general law of unconscionability would strike down such exculpatory and one-sided terms in a contract not involving arbitration, that law is overridden by the FAA so long as such provisions are included in a section of a contract that *also* includes an arbitration provision. Nothing in the FAA permits parties to launder otherwise illegal contract terms and make them legal merely by sticking them under the heading of “arbitration,” however, and this Court has never so held. As the West Virginia Supreme Court has held, the FAA does not allow for this kind of escape from state contract liability “merely because the prohibiting or limiting provisions are part of or tied to provisions in the contract relating to arbitration.” *Dunlap* 567 S.E.2d at



280.

In fact, the Court of Appeal's discussion reflects a mind-set that is flatly antithetical to that of the FAA. As the court below recognized, the purpose of the FAA was to "reverse the longstanding judicial hostility to arbitration agreements. . . ." 105 Cal. App. 4<sup>th</sup> at 337, 129 Cal. Rptr. 2d at 401 (citation omitted). Immediately after recognizing this principle, however, the Court of Appeal proceeded to violate it and rely upon gross hostility to arbitration to support its insistence that class actions must not be permitted in arbitration:

As judicial review of the merits of an arbitrator's decision may not be had under California law, a multi-million dollar class arbitration award entered on nothing more than mere whim cannot be corrected under California law. Just as consumers may be harmed by the enforcement of an unconscionable class action waiver, defendant companies may be able to prove that they will be prejudiced if classwide arbitration is imposed where, even though the arbitration agreement is silent on the subject, the agreement has adopted arbitration rules, such as those of the AAA, that do not provide for classwide arbitration.

105 Cal. App. 4<sup>th</sup> at 348, 129 Cal. Rptr. 2d at 409-10. In other words, the Court of Appeal was concerned that arbitrators should not be permitted to handle important cases that might cost a corporate defendant a lot of money, because arbitrators might do a poor job (i.e., decide the case on "mere whim") and because with arbitration generally, there is little judicial review available. This argument plainly demonstrates a hostility to arbitration.

Under this rationale, of course, arbitration should not be available for *any* important cases. Thus, if one began with the premise that denying justice to persons whose civil rights were violated or who had been cheated in violation of consumer protection statutes was as important as denying justice to a corporation defendant a class action, then following the rationale

of the court below would necessarily lead to the conclusion that no mandatory arbitration could be allowed for individual consumer or employment cases either. The U.S. Supreme Court has flatly rejected this proposition, however. In *Gilmer*, the plaintiff argued that civil rights claims could not be forced into arbitration precisely because there was no meaningful judicial review of arbitrators' decisions: 500 U.S. at 32 n.4. The Supreme Court rejected that argument, however, in its rejection of all arguments that represent a "generalized attack[] on arbitration." *Id.* at 30.

#### **IV. A NUMBER OF OTHER COURTS HAVE HELD THAT CONTRACTUAL WAIVERS OF CLASS ACTIONS IN ARBITRATION CLAUSES ARE UNCONSCIONABLE.**

The Court of Appeal's decision below gives the impression that the only authority for the proposition that arbitration clauses may not conscionably ban class actions is the *Szetela* case. In fact, the *Szetela* case hardly stands alone on this issue. In addition to the *Ting* case discussed above, two other state high courts have joined with *Szetela* in the last year in finding arbitration clauses that ban class actions to be unconscionable, and thus unenforceable, under state law. The Alabama Supreme Court recently found a contract term banning class actions built into an arbitration clause to be unconscionable. *See Leonard v. Terminix Int'l Co.* (Ala. Oct. 18, 2002) 2002 WL 31341084 (petition for rehearing denied).<sup>7</sup> The Court made a point of noting that such a ban affects rich and poor alike, as it forecloses *all* individual plaintiffs from bringing a claim where the expense of arbitrating is greater than the amount in controversy. "That the expenses

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<sup>7</sup> In *Leonard*, the arbitration clause was silent on whether the parties could pursue a class action, but the Court found such a remedy barred because class action arbitration is not possible in Alabama. *Leonard*, 2002 WL 31341084 at \*5, n.2.

of arbitration would exceed the amount in controversy is not a problem personal or peculiar to any particular consumer but is, rather, a phenomenon inherent in the transaction itself.” *Leonard*, 2002 WL 31341084 at \*7. By “foreclosing the Leonards from an attempt to seek practical redress through a class action and restricting them to a disproportionately expensive individual arbitration,” the Court found that the defendants had essentially closed the door of justice to these consumers. *Id.* at \*8. Thus, the arbitration clause was unconscionable.

Similarly, in *Dunlap*, 567 S.E.2d at 278, the West Virginia Supreme Court of Appeal held that an arbitration clause which effectively barred class actions under state law was unconscionable. The court’s reasoning was rooted in that state’s longstanding law prohibiting exculpatory clauses in contracts of adhesion:

Based on all of the foregoing and in fidelity to the approach that we have taken in this area, we recognize and hold that exculpatory provisions in a contract of adhesion that if applied would prohibit or substantially limit a person from seeking and obtaining and vindicating rights and protections or from seeking and obtaining statutory or common law relief and remedies that are afforded by or arise under state law that exists for the benefit of the public are unconscionable; unless the court determines that exceptional circumstances exist that make the provisions conscionable.

567 S.E.2d at 275. In *Dunlap*, the Court explained that in light of the modest claims at issue, the defendant’s contractual ban on class actions was effectively an unconscionable exculpatory clause. “In Mr. Dunlap’s case, the total of \$8.46 in insurance charges that Friedman’s added to his purchase price by Friedman’s [sic] is precisely the sort of small-dollar/high volume (alleged) illegality that class action claims and remedies are effective at addressing.” The court went on to find that “[i]n many cases, the availability of class action relief is a *sine qua non* to permit the adequate

vindication of consumer rights.” The court warned that “[t]hus, in the contracts of adhesion that are so commonly involved in consumer and employment transactions, permitting the proponent of such a contract to include a provision that prevents an aggrieved party from pursuing class action relief would go a long way toward allowing those who commit illegal activity to go unpunished, undeterred, and unaccountable.” *Dunlap*, 567 S.E.2d. at 278-79.

A number of other courts have reached the same conclusion. *See Luna*, 236 F.Supp.2d 1166, 1179 (“Here, the prohibition on class actions allows the Arbitration Rider to be ‘used as a sword to strike down access to justice instead of a shield against prohibitive costs.’ This finding weighs heavily in favor of a finding of substantive unconscionability.”) (citations omitted); *Comb v. Paypal*, 218 F. Supp.2d 1165, 1176-1177 (following *Szetela* and finding arbitration clause unconscionable, in part because it prohibited collective actions; rejecting argument of FAA preemption in light of the Ninth Circuit’s decision in *Ticknor*); *ACORN v. Household Intnat’l, Inc.*, 211 F. Supp.2d at 1170-1171 (following *Szetela* and the district court opinion in *Ting*, holding that an arbitration clause that prohibited class actions was unconscionable); *Powertel v. Bexley* (Fla.App. 1 Dist. 1999) 743 So. 2d 570, 576 (“By requiring arbitration of all claims, Powertel has precluded the possibility that a group of its customers might join together to seek relief that would be impractical for any of them to obtain alone.”); *Bailey v. Ameriquest Mortgage Co.* (D.Minn. Jan. 23, 2002) 2002 WL 100391, \*7 ([T]he inability to proceed collectively . . . has the effect of rendering plaintiff’s individual claims impractical to pursue. The right to proceed collectively is particularly critical to these plaintiffs, who, as previously mentioned, have relatively small individual claims.”); and *In re Knepp* (N.D. Ala. 1999) 229 B.R. 821, 827 (“The pervasive use of

arbitration agreements in consumer contracts could have the effect of eliminating class actions. If class actions are no longer an option, the vast majority of consumer claims involving relatively small sums of money on an individual basis will be left without a remedy.”<sup>8</sup>

These cases establish that, notwithstanding a few federal courts that have rejected superficially similar arguments, there is widespread judicial approval of the principles enunciated by this Court in *Keating* and the Court of Appeal in *Szetela*, and rejected by the court below in this case.

Discover particularly relies upon one case, *Champ v. Siegel Trading Co.* (7<sup>th</sup> Cir. 1995) 55 F.3d 269, to support its claim that the FAA overrides any state laws relating to class actions. *Champ* does not involve § 2 of the FAA (from which the U.S. Supreme Court has derived the concept of FAA preemption), or an unconscionability challenge to an arbitration clause. Instead, *Champ* rests on FAA § 4, which is inapplicable in state court. *See* 9 U.S.C. § 4 (regarding procedure to be used in “any United States district court” to initiate arbitration in cases presenting federal claims). The case has no bearing here.

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<sup>8</sup> One decision to the contrary is the Fourth Circuit’s holding in *Snowden v. CheckPoint Check Cashing* (4<sup>th</sup> Cir. 2002) 290 F.3d 631 that a prohibition on class actions is not unconscionable. This decision can best be explained by differences in the underlying state law of unconscionability between California and Maryland (where the *Snowden* case originated). In *Gilman v. Wheat, First Securities* (Md. 1997) 692 A.2d 454 (Md. 1997), for example, Maryland’s Court of Appeals enforced a forum selection clause that would require consumers to bring any case in Virginia (which does not permit class actions), and Maryland’s high court held that this forum selection clause was not unconscionable under Maryland law. This rule of Maryland state contract law, which differs from California law as set forth above and as exemplified in cases such as *AOL*, explains why the Fourth Circuit’s decision does not conflict with cases such as *Szetela* and *Ting*, but instead merely involves an application of a different state’s particular contract law.



## CONCLUSION

For the foregoing reasons, this Court should reverse the decision of the Court of Appeal.

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**CERTIFICATION REGARDING  
LENGTH OF BRIEF**

I hereby certify that this brief contains 62,046 words, including footnotes, as established by the work count of the computer program used for the preparation of this brief.

I declare and certify under the laws of the State of California that the foregoing statement is true and correct and that this certification was executed on May 8, 2003, in Oakland, California.

By:

\_\_\_\_\_

\_\_\_\_\_

Kate Gordon  
Attorney for Plaintiff and  
Petitioner



PROOF OF SERVICE BY MAIL

I, the undersigned, certify and declare that I am a citizen of the United States, over the age of 18 years, employed in the City of Oakland, County of Alameda, and not a party to this action. My business address is One Kaiser Plaza, Suite 275, Oakland, California, 94612.

I am readily familiar with Trial Lawyers for Public Justice's practice for collection and processing of documents for mailing with the United States Postal Service, being that the documents are deposited with the United States Postal Service with postage thereon fully prepaid the same day as the day of collection in the ordinary course of business.

On May 9, 2003, I served the within **Opening Brief on the Merits** on the parties in this action listed below by placing a true copy thereof in a sealed envelope and depositing with the U.S. Postal Service, addressed as follows:

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I declare under penalty of perjury under the laws of the State of California that the foregoing is true and correct, and that this declaration was executed on May 9, 2003 at Oakland, California.

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