Tort Law

Arbitration Clauses Which Limit Plaintiffs' Remedies Are Unenforceable

by Christopher H. Hagen, Column Editor

Chris Hagen is a partner at the law firm of Naumann & Levine, LLP. He concentrates his practice in construction defect and business litigation. Mr. Hagen received his undergraduate degree from Pennsylvania State University and his Juris Doctor degree from the University of San Diego. Mr. Hagen became the Tort Law Column Editor for ***Trial Bar News*** *this year. He may be reached via e-mail at:* ***chagen@nl-law.com.***

Two recent decisions address the enforceability of contractual arbitration clauses which attempt to limit plaintiffs' remedies: *Harper v. Ultimo* 2003 *Daily Journal D.A.R.* 13,225; and *Gutierrez v. Autowest Inc.* 2003 *Daily Journal D.A.R.* 13,405. In both cases, the appellate courts declined to enforce the arbitration clauses. The arbitration provisions were found deficient for the following reasons: (1) imposition of substantial costs without provision for waiver; (2) inability to negotiate clause; (3) limitation of amount of damages recoverable; (4) limitation of types of damages recoverable; and (5) incorporation of unattached arbitration rules which are subject to change.

Harper v. Ultimo is a Fourth District, Division 3, decision which also clarifies that adhesion is not a prerequisite for unconscionability. Therefore, you may still be able to defeat an arbitration clause despite your client having negotiated and/or initialed the clause.

FACTS

Harper v. Ultimo, supra, involved a contract between homeowners and a contractor to stabilize and relevel a swimming pool. The contract was preprinted, but certain terms were negotiated by the parties. The contract contained an arbitration clause which incorporated by reference the Uniform Rules for Better Business Bureau Arbitration ("BBB"). The contractor

damaged the existing drainage system, broke a sewer pipe and clogged the plumbing system with concrete.

The Harpers subsequently discovered that the BBB limited their remedies as follows:

> **The following remedies may be awarded in an arbitration proceeding: a) full or partial refund of the cost of the product and/or service involved in the transaction, including sales tax and other direct incidental costs associated with the sale of the product or service; b) completion of promised work or fulfillment of contractual obligations; c) repairs, or reimbursement for the cost of repairs, to fix a defective product; and/or, d) the amount of any actual out of pocket loss or property damage, not to exceed $2,500, caused by the provision of the service.**

See, www.dr.bbb.org. The Harpers would have been foreclosed from recovering either punitive damages or attorneys' fees. They also would not have been compensated for any resultant property damage exceeding $2500.

Gutierrez v. Autowest Inc., supra, involved a car lease. An unfair business practices suit was subsequently filed alleging a "bait and switch" scheme. The pre-printed lease contained an arbitration clause which invoked the United States Arbitration Act and the rules of the American Arbitration Association ("AAA"). The clause read as follows:

> **Any controversy or claim between or among you and me, including, but not limited to, those arising out of or relating to this lease or any related agreements or any claim based on or arising from an alleged tort, shall at the request of either party be determined by arbitration. The arbitration shall be conducted in accordance with the United States Arbitration Act (Title 9, U.S.Code), notwithstanding any choice of law provision in this lease, and under the authority and rules of the American Arbitration Association then in effect. No provision of this paragraph shall limit either your or my right to pursue self-help or to obtain provisional or ancillary remedies from a court of competent jurisdiction before, after, or during pendency of any arbitration. The exercise of any provisional remedy or the filing of a legal action, does not waive the right of either party to resort to arbitration.**

Gutierrez v. Autowest Inc., supra, 2003 *Daily Journal D.A.R.* 13,405. The clause was on the back side of the lease in eight-point typeface. The clause was not negotiated, initialed or noticed by Mr. Gutierrez when the contract was executed.

TRIAL COURT

The court in *Harper v. Ultimo, supra,* declined to find that the contract was adhesive since numerous market alternatives existed, ruling that had the Harpers attempted to negotiate away the arbitration provisions and failed, they could have hired a different contractor. Nevertheless, the trial court still found that the arbitration clause was unconscionable and therefore unenforceable.

The court in *Gutierrez v. Autowest Inc., supra*, examined the proposed arbitration costs and plaintiff's ability to pay same. The court then determined the arbitration clause to be unenforceable due to the lack of both an independent cost allocation provision and a severability clause.

THE BASICS

Unconscionability depends upon a finding of both procedural and substantive unconscionability. Both of these factors must be present; however, a sliding scale analysis is employed whereby the more one factor is present then the less the other factor need be present.

Procedural unconscionability involves the manner in which the agreement is effectuated. Factors to be considered include the following: (1) whether the parties were of equal bargaining strength; (2) whether the contract terms were clearly drafted, sufficiently conspicuous and/or fully outlined; and (3) whether the parties had a sufficient opportunity to review, understand and/or negotiate the terms.

Substantive unconscionability involves the effect of the agreement upon the parties. One-sided agreements that operate in favor of the drafter and have an overly harsh effect upon the other party may be substantively unconscionable. Courts consider the degree to which such agreements "shock the conscience".

APPELLATE ANALYSIS

The Fourth District in *Harper* found both procedural and substantive unconscionability. Regarding procedural unconscionability, the court noted that the clause resulted in both surprise and oppression. Surprise existed because regardless how carefully the homeowners were to read the contract they would not know the arbitration clause limits their ability to recover. The limiting terms were in a document not presented or attached to the contract. The homeowners would not be able to obtain full relief whether they are actually victims of fraud or are merely seeking reimbursement for out-of-pocket property damages.

Oppression existed due to incompleteness of the contract. The contract incorporates the BBB rules by reference. The contractor should have provided the Harpers with a copy of the BBB rules existing at the time of making the contract and incorporated them into the contract so that known terms were used rather than whatever set existed at the time of the dispute. The *Harper* court noted that oppression may exist even if the homeowners had reviewed the current BBB rules if those change prior to the dispute being heard.

Regarding substantive unconscionability, the court noted that this was another "heads I win, tails you lose" arbitration clause. The court focused upon the fact that by limiting those claims which could be asserted, the clause effectively eliminated the possibility that the consumer could obtain full relief. The contractor argued that was fair since the clause also limited those claims which he could assert against the homeowners in a dispute. The court succinctly dismissed this mutuality of remedy argument by recognizing the following:

> **The odds were far more likely that the customers would have claims in addition to just getting their money back than the business would have claims in addition to just getting paid.**

Given the presence of both procedural and substantive unconscionability, the arbitration provisions were therefore unenforceable.

However, the *Harper* court continued on to clarify that adhesion is not a prerequisite for unconscionability. The decision contains some language which will be helpful in defeating market alternative arguments, such as the argument that if the Harpers did not like Mr. Ultimo's contract they could have simply hired a different contractor and should have done so.

The First District in *Gutierrez v. Autowest Inc., supra,* focused upon the arbitration costs imposed upon the consumers via the lease clause. The lessees lodged a copy of the AAA rules and filed Declarations explaining they could not afford the arbitration costs. The *potential* value of plaintiffs' claims was estimated at $500,000. The trial court determined that the AAA filing fees for such a claim would exceed $10,000. When compared to the court's filing fees it became apparent that compelling arbitration would impose a significant financial burden upon plaintiffs. Further, these plaintiffs would effectively be barred from obtaining any relief due to such forum costs. AAA rules apparently do not contain any fee waiver provisions for indigents.

The *Gutierrez* court concluded that since the arbitration clause did not contain a cost allocation provision, the contract was unconscionable and unenforceable since it effectively barred plaintiffs from any forum to obtain relief. It did not matter that plaintiffs may have later obtained reimbursement of costs/fees pursuant to the AAA rules. It did not matter that overall costs involved in litigation may eventually exceed those of arbitration. This argument was speculative. What was needed was a contractual term either stating the drafter would initially pay all costs or enabling plaintiffs to obtain a fee waiver or reduction.

Severability was addressed by both the *Gutierrez* court and the *Harper* court. Severability is within the trial court's discretion. The decision not to sever was upheld in *Harper* since the result "would be a mess". The trial court's determination in *Gutierrez* that severance was impermissible resulted in a remand with instructions to reconsider the issue. The *Gutierrez*

court directed that if cost was the only issue raised regarding unconscionability then severance and enforcement might be possible.

CONCLUSION

Both the *Gutierrez* and *Harper* decisions should be reviewed by any attorney whose client has entered into a contract with an arbitration provision which attempts to limit the claims which he or she can assert or the damages which can be recovered. Attorneys need to thoroughly review not only the contract and arbitration clause, but also the rules under which the arbitration is to be conducted.

If the client has separately initialed the arbitration clause that does not end the analysis. The *Harper* decision can be used to explain that adhesion is not a prerequisite for unconscionability. Both procedural and substantive unconscionability can exist regardless of issues such as the type size of the font, whether the clause was pointed out, separately initialed, negotiated, etc.

If the client is not wealthy then look at the costs required to initiate arbitration. They will be higher then the court's filing costs. For a list of AAA's current commercial dispute filing fee schedule, see **www.adr.org**.

If you can claim punitive damages then include those within your estimated claim amount. Submit declarations from your client since financial inability is a case-by-case determination upon which you bear the burden of proof. Further, do not rely solely upon this ground or you may face a severance issue. Raise as many other issues supporting both procedural and substantive unconscionability as are applicable.

In summary, answers to questions such as the following should be explored before any arbitration proceeds pursuant to either a clause or rules which limit a plaintiff's claims and/or

recovery:

1. Was the arbitration clause ever pointed out to you?

2. Were you ever provided or shown a copy of the arbitration rules to which the clause refers?

3. Have the arbitration rules substantively changed since the contract was entered into?

4. What is the *potential* value of your claim (include punitive damages, if applicable)?

5. How much would it cost you to initiate the arbitration?

6. Can you afford that?

7. Is there any provision in the clause or rules for those costs to be waived / reduced?

8. What claims or remedies would you be foreclosed from asserting or recovering under the proposed arbitration rules?

9. Are you barred by either the clause or the rules from asserting any unwaivable statutory claims in violation of public policy?