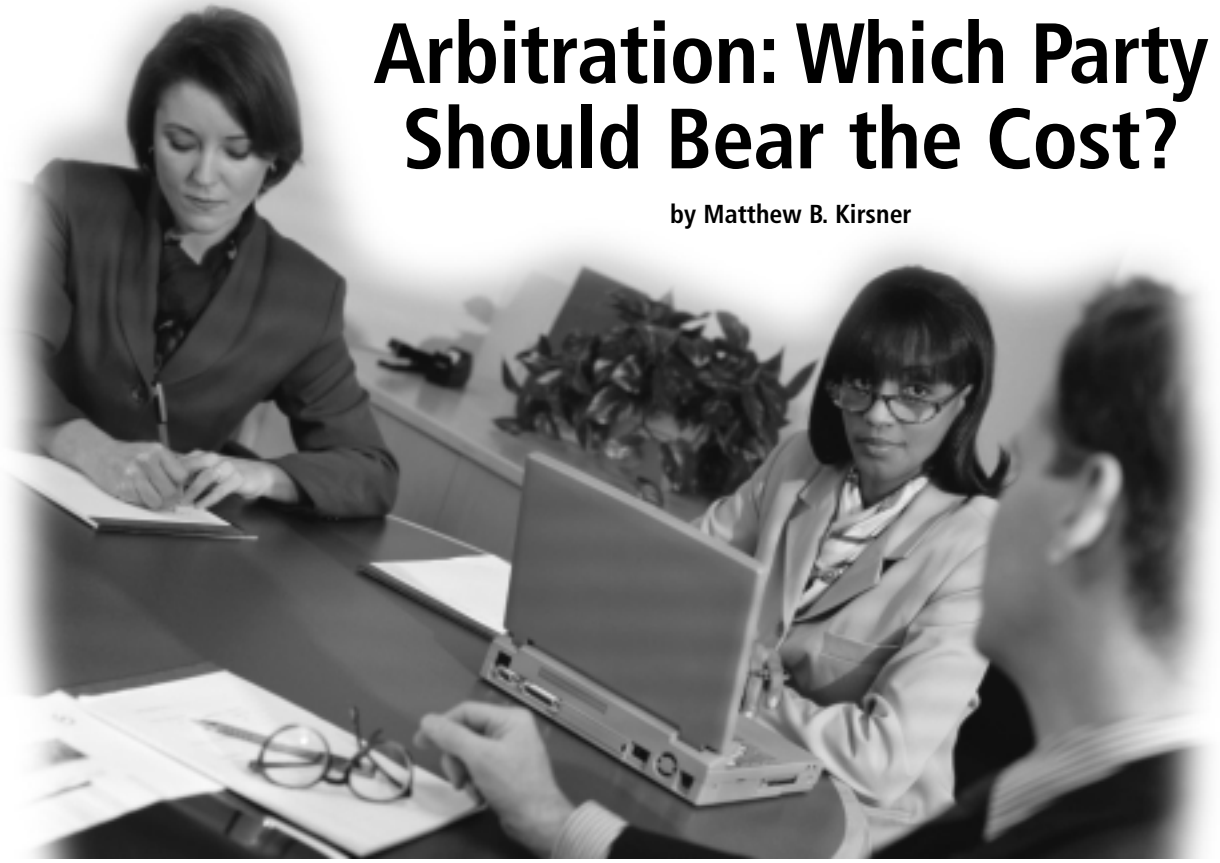
Arbitration: Which Party Should Bear the Cost?

by Matthew B. Kirsner



Virginia practitioners are well-aware that federal law strongly favors arbitration. Arbitration has now become an important part of the dispute-resolution landscape. Whole industries, such as securities brokerage and construction, have embraced arbitration as an expedient and relatively low-cost alternative to traditional litigation. However, over the last decade, a steady and rapid spread of arbitration clauses has emerged in contracts between businesses and individual consumers, particularly in the consumer finance industry. Corporate risk aversion and cost-cutting, rather than consumer demand, are driving the latest proliferation of arbitration clauses. While businesses may favor arbitration for a number of reasons, the primary rationale is to use arbitration as a means to avoid both juries and class-action litigation.

When arbitration clauses are incorporated into contracts with unwilling (or unwitting) consumers, subsequent disputes must first wrestle with the enforceability and desirability of these arbitration agreements. In particular, courts have become concerned that mandatory arbitration clauses may actually foreclose *any* remedy by posing insurmountable costs. While courts are subsidized by the taxpayers, arbitration is not. Up-front filing fees of $2,000 or more, case administration fees and hourly fees for arbitrators can lead to a total bill in excess of the total of the claim and in excess of what an individual claimant can afford to pay.

The U.S. Supreme Court opened the door to litigation regarding the "costs" of arbitration in *Green Tree Financial Corp.–Alabama v. Randolph*, 531 U.S. 79 (2000). A plaintiff seeking to overcome the presumption in favor of arbitration may now prevail by demonstrating the likelihood of incurring "prohibitive" arbitration expenses.

The *Randolph* opinion has set the stage for ongoing challenges to arbitration agreements by consumers based on cost. Indeed, Virginia's federal district and appellate courts have begun to apply this new doctrine in evaluating arbitration clauses ancillary to consumer transactions. In at least one Virginia case, an arbitration clause has, in fact, been declared unenforceable. *See Camacho v. Holiday Homes*, 167 F. Supp.2d 892, 897 (W.D.Va. 2001). From a business perspective, a successful attack on its arbitration clause bespeaks a determined plaintiff's lawyer who is angling for a jury, and an adversary who has evaluated a particular case as being worth the time, paperwork and risk necessary to defeat the clause in order to pursue traditional litigation. In sum, because *Randolph* blazes a trail around arbitration, businesses desiring arbitration need to take action to even the playing field.

The "Cost" Issue

The American Arbitration Association's rules provide a snapshot of the typical fees and costs that may be encountered by a consumer seeking to vindicate her rights in the arbitration forum. The party initiating the dispute resolution must advance the filing fee. Claims of $10,000 or less require a non-refundable filing fee of $500. The fee for claims above $10,000 and less than $75,000 is $750. Claims above $75,000 and less than $150,000 require a filing fee of $1,250 and a case service fee of $750.

Cases requiring three or more arbitrators require a filing fee of $2,750 and a $1,000 case service fee.

The rules also provide that the arbitrator's compensation and related administrative fees are subject to allocation by the arbitrator in the award (unless the parties agree otherwise). As a means to eliminate initial financial barriers, the AAA may grant a "hardship" deferral or reduction of administrative fees, but other arbitration costs (e.g., arbitrator's fees, room rental and witness expenses) are not deferred or reduced. Advance deposits of arbitrators' fees may be required. Failure to make payments for arbitrator compensation or administrative charges may result in suspension or termination of the proceedings.

The *Randolph* Case

In *Green Tree Financial Corp.-Alabama v. Randolph*, 531 U.S. 79 (2000), the U.S. Supreme Court addressed the issue of whether "an arbitration agreement that does not mention arbitration costs and fees is unenforceable because it fails to affirmatively protect a party from potentially steep arbitration costs."[1] Randolph purchased a mobile home and financed it through Green Tree.[2] The finance contract "provided that all disputes arising from, or relating to, the contract, whether arising under case law or statutory law, would be resolved by binding arbitration."[3] A key issue in the lower court's evaluation of the arbitration agreement was the omitted details regarding filing fees and arbitrators' costs.[4] The clause failed to specify which rules would be applied, the place of arbitration or how the arbitration expenses would be paid.[5]

The Supreme Court held that a party seeking to invalidate an arbitration agreement on the grounds that arbitration would be prohibitively expensive bears the burden of showing the likelihood of incurring such costs.[6] The mere absence of details regarding arbitration costs is insufficient to render an arbitration clause *per se* unenforceable.[7] Likewise, the mere "risk" of incurring heavy financial burdens was too speculative to justify the invalidation of an arbitration agreement.[8] However, if a party can show the likelihood of incurring "significant costs," she may avoid arbitration and pursue judicial remedies.[9] Ironically, although the court recognized that the transaction costs inherent to arbitration might operate as a barrier to entry, it placed additional costs on parties seeking to prove that their claims are unsuitable for arbitration.[10]

The Court did *not* reach the issue of "[h]ow detailed the showing of prohibitive expenses must be before the party seeking arbitration must come forward with contrary evidence." Nonetheless, the Court noted that Randolph's "discussion of arbitration costs relied entirely on unfounded assumptions," i.e., she assumed that the filing fee would be $500 (without providing any supporting documentation), and Randolph estimated that the average arbitrator's fee would be $700 per day (based upon a stray reference in a newsletter article).[12]

Virginia Courts' Application of *Randolph*

In the wake of *Randolph*, a court determining whether a federal statutory claim must be arbitrated must resolve three issues: whether the parties agreed to submit their claims to arbitration; whether Congress intended to preclude a waiver of judicial remedies for the disputed statutory rights; and whether the arbitration clause prevents the claimant from effectively vindicating her federal statutory rights because the costs of arbitration render the alternative dispute resolution forum virtually inaccessible. *Camacho v. Holiday Homes Inc.*, 167 F. Supp.2d 892, 895 (W.D.Va. 2001).

The *Camacho* plaintiff bought a mobile home under a retail installment agreement from defendant.[13] Problems arose with the home, and plaintiff retained a legal aid attorney to file suit *in forma pauperis* under the Truth in Lending Act and the Uniform Commercial Code.[14] Defendant moved to compel arbitration.[15]

As with *Randolph*, the pre-printed retail installment contract contained an arbitration clause, but did not mention arbitration costs or which party would be responsible for paying them.[16] The arbitration clause merely stated that the "Commercial Rules of the American Arbitration Association . . . apply."[17] For purposes of defendant's motions, the parties stipulated that the initial AAA fees included a $1,250 filing fee and a $750 case fee.[18] After filing, the case could not proceed until the parties paid the arbitrator's fees and expenses ($100 to $300 per hour, minimum of one day).[19] The total arbitration costs would vary between $1,200 and $8,000.[20]

Virginia's state courts have not explicitly adopted Randolph, but have echoed its rationale regarding the "likelihood of incurring significant costs" as a means to invalidate arbitration provisions.

Based on her dire economic straits, plaintiff objected to defendant's motion to compel arbitration because she could not afford to pay any significant costs associated with arbitrating the dispute.[21] Plaintiff submitted a declaration of her monthly debts, expenses and average weekly wages.[22] Ms. Camacho earned an average of $15,600, was the sole provider for her three young children, and owed over $14,000 in student loan debts.[23]

The district court cited *Randolph* for the proposition that a party who can show the likelihood of incurring significant costs may avoid arbitration.[24] The court held that plaintiff had met her burden under the *Randolph* standard ("Camacho has presented substantial evidence that the costs of arbitrating her claims would preclude her from vindicating her federal statutory rights"), and declared the arbitration clause to be unenforceable.[25] In particular, the court noted that the AAA rules did not provide any

means for the claimant to recover the filing and case fees (unless Camacho ultimately prevailed), and the "hardship" fee deferral process was rarely successful.[26] Even if the initial $2,000 in fees were waived, "the additional costs of the arbitration process itself amount to an insurmountable financial barrier to her."[27]

As a final caveat to its memorandum opinion, the *Camacho* court noted that if defendant agreed to bear all of the arbitration costs, the court would reconsider its ruling.[28] This tactic has proved successful outside of Virginia. *See, e.g., In re Cavanaugh*, 271 B.R. 414, 421 n.6 (Bkrtcy. D. Mass. 2001) (defense counsel undercut plaintiff's *Randolph* rationale by offering to pay the parties' arbitration costs).

The *Randolph* opinion (as interpreted by *Camacho*) has been applied outside the consumer finance arena to evaluate an arbitration agreement ancillary to an insurance policy in *Russell County School Board v. Conseco Life Ins. Co*., 2001 WL 1593233 (W.D. Va. Dec. 12, 2001). Despite the industry distinctions, the *Conseco* opinion provides some guidance on the manner in which proving "prohibitive expenses" can be an elusive target. An insurance policy issued to plaintiff for reimbursement of excess medical expenses required travel from Southwest Virginia to Chicago in order to arbitrate any disputes between the parties.[29] The district court found that the school board had not borne its burden under *Randolph* to show that arbitration would be prohibitively expensive.[30] The plaintiff introduced evidence regarding its present financial status, e.g., an affidavit detailing recent debts incurred and staff lay-offs.[31] The court compared this case to *Camacho*, and distinguished the school board's financial difficulty from a total inability to pay the costs associated with arbitration.[32] Further, since the losing party would be responsible for the arbitration costs, the court cannot invalidate the arbitration agreement based merely on a "risk of costs" (which was already rejected by the U.S. Supreme Court in *Randolph*).[33] The parties were ordered to proceed with arbitration.[34]

In contrast to the successful fee-based challenge in *Camacho*, the Fourth Circuit rejected a similar arbitration clause challenge in *Sydnor v. Conseco Financial Servicing Corp*., 252 F.3d 302 (4th Cir. 2001). The plaintiffs (two elderly sisters) were solicited by a home improvement contractor (AAPCO).[35] AAPCO arranged for financing from defendant Conseco, and the plaintiffs signed a financing agreement containing a mandatory arbitration clause.[36] After a dispute arose over a subcontractor's work, plaintiffs filed suit alleging claims under the Truth in Lending Act, the Virginia Consumer Protection Act, fraud and conspiracy.[37] Defendant moved to compel arbitration, but the district court (echoing the Eleventh Circuit's opinion in *Randolph*) denied the request, in part, because the unknown arbitration fees, costs and procedures did not adequately protect plaintiff's rights and rendered the agreement unconscionable.[38] Conseco filed an interlocutory appeal.

The Fourth Circuit considered the limited circumstances where an arbitration clause would be unconscionable, i.e., a contract is "one which no reasonable person would enter into," and the "inequality must be so gross as to shock the conscience."[39] The court cited its decision in *Hooters of America v. Phillips*, 173 F.3d 933 (4th Cir. 1999), where an arbitration agreement was invalidated due to a "multitude of biased and warped rules . . . which essentially created a 'sham [arbitration] system' which the court refused to enforce."[40]

The court found that the failure of Conseco's arbitration agreement to address fees and costs did *not*—without more—make the agreement unenforceable.[41] The *Sydnor* plaintiffs had provided "little evidence" justifying a conclusion that arbitration would be prohibitively expensive.[42] Further, Conseco proffered that it was willing to pay the arbitration fees.[43] Thus, the agreement was not "unconscionable because of unknown cost, fees, and procedures."[44]

Virginia's state courts have not explicitly adopted *Randolph*, but have echoed its rationale regarding the "likelihood of incurring significant costs" as a means to invalidate arbitration provisions. For example, a Virginia Circuit Court has held that the buyers of an allegedly defective automobile were not required to arbitrate their claims under the service contract purchased with the vehicle. In *Philyaw v. Platinum Enterprises Inc*., 2001 WL 112107 (Spotsylvania County Cir. Ct. Jan. 9, 2001), the arbitration agreement was found to be "patently unconscionable" because it required the proceedings to occur in Los Angeles, California; each party was to bear its own attorneys' fees and witness expenses; and the parties were to equally share the costs of arbitration and the arbitrator's fees regardless of which party prevails.[45] The court found that the vehicle service agreement was akin to a "contract of adhesion . . . even if the consumers understood the ramifications of the arbitration clause, they could not have bargained for better terms under the circumstances of this case.[46]

For similar holdings in other jurisdictions that have applied and interpreted *Randolph*, see, *e.g., Phillips v. Associates Home Equity Services, Inc*., 2001 WL 1159216 at *4-5 (N.D. Ill. Sept. 28, 2001) (prohibitive costs invalidated arbitration agreement contained within residential mortgagor's loan contract; defendant specialized in "sub prime" lending market; lead class plaintiff provided evidence of AAA costs and affidavit of her inability to pay; court accepted plaintiff's "reasonable good faith effort to estimate her arbitration costs." Hardship inquiry must be determined on a "case-by-case basis."); *Gilkey v. Central Clearing Co*., 202 F.R.D. 515, 522-23 (E.D. Mich. 2001) (class action plaintiffs may seek to invalidate an arbitration agreement on the grounds of prohibitive costs; class certification for consumer fraud claim on "payday" loans granted); *Burden v. Check Into Cash of Kentucky, LLC*, 267 F.3d 483, 492, 493 (6th Cir. 2001) (case remanded for trial court's determination of whether plaintiffs have met their burden of showing the likelihood that "arbitration would be prohibitively expensive."); *Ball v. SFX Broadcasting, Inc*., 165 F. Supp.2d 230, 239-40 (N.D.N.Y. 2001) (arbitration agreement that requires an employee asserting federal statutory rights to pay "significant" arbitration costs is unenforceable; it is the particular financial position of a party seeking to invalidate an arbitration agreement that is the crucial factor; AAA is not the sole forum for pleading financial hardship); *Geiger v. Ryan's Family Steak Houses, Inc*., 134 F. Supp.2d 985, 995, 996 n.5 & 997 (S.D. Ind. 2001) (district court invalidated the arbitration agreement, in part, because the fee structure was unduly burdensome by requiring the employees to pay 50% of more of the arbitration panel's fees in advance (up to $2,000). Court distinguished *Randolph* on the basis that

the arbitration rules clearly outline the proposed fee structure and place an inordinate burden on the employee); *Ting v. AT&T*, 182 F. Supp.2d. 902, 934 (N.D. Cal. 2002) (arbitration clause deemed unconscionable due to AAA fees, limitation on damages, and prohibitions on the joinder of claims and use of class actions).

Lessons from *Randolph*

As a result of *Randolph*, businesses desiring arbitration clauses in their contracts with consumers have to make a basic choice: either agree to pay most (or all) filing and administrative fees in order to make the arbitration clause relatively "bullet proof" against a *Randolph* argument, or ignore the cost issue and take the risk that the clause will be deemed unenforceable due its allegedly insurmountable financial barriers. If the business chooses the former course, then its arbitration clause might incorporate some general language on costs, e.g.:

If you bring a claim subject to arbitration, you will pay toward the fees and deposits imposed by the American Arbitration Association or other arbitrator only an amount equal to the amount you would have had to pay as filing fees and initial court costs if you had filed suit in a court of competent jurisdiction. The company will pay the remainder of the fees and deposits of arbitration. In the event that you substantially prevail in the arbitration, the company will reimburse the fees and deposits you have paid.

Placing a cap on the claimant's out-of-pocket costs may rebut the *Camacho* scenario where arbitration expenses are deemed "likely" to be prohibitive.

On the other hand, consumers seeking to invalidate an arbitration provision on "cost" grounds must now submit a detailed financial declaration to the district court. The key element under *Randolph* is plaintiff's ability to demonstrate the "likelihood" of incurring these particular arbitration costs, and the implication that these cost will make arbitration "prohibitively expensive." Recall the claimants' failure in *Randolph* and *Sydnor* to substantiate this element of their objection to the lenders' motion to compel arbitration. The plaintiff's statement must contain *actual*—not hypothetical—cost estimates for pursuing arbitration, including: costs attributable to each specific element of the fee structure (e.g., filing fee, administrative costs, witness fees, room rental, arbitrator compensation, and travel costs); and documentary support for each component of the cost estimate, i.e., citations to the applicable arbitration entity's rules (e.g., AAA). For obvious reasons, the district court cannot apply a bright-line rule to determine the "prohibitive" nature of arbitration costs. Thus, in addition to information about the costs "likely" to be incurred, the claimant must place these costs in the context of her personal financial situation. Details regarding monthly income and expenses, outstanding debts and the lack of collateral are particularly relevant. ⚖

Matthew B. Kirsner is an associate with Troutman Sanders, L.L.P., in Richmond, where he practices in the Complex Litigation and Telecommunications/E-Commerce Practice Groups. He received his J.D. from George Mason University School of Law in 1997, and his B.A. from The College of William and Mary in 1992. Mr. Kirsner would like to thank Robert D. Seabolt and Alan D. Wingfield of Troutman Sanders L.L.P. for their valuable contributions to this article.

Endnotes:

1 *Id.* at 82.
2 *Id.*
3 *Id.* at 82-83.
4 *Id.* at 84, 89.
5 178 F.3d 1149, 1158.
6 531 U.S. at 91.
7 *Id.*
8 *Id.*
9 *Id.* at 90, 92.
10 *Id.* at 93 (Ginsburg, J., concurring in part and dissenting in part).
11 *Id.* at 92.
12 *Id.* at 90 n.6.
13 *Id.* at 893.
14 *Id.*
15 *Id.*
16 *Id.*
17 *Id.*
18 *Id.* at 894.
19 *Id.*
20 *Id.*
21 *Id.* at 895.
22 *Id.* at 894.
23 *Id.* at 892, 894-95.
24 *Id.*
25 *Id.* at 896, 897.
26 *Id.* at 897.
27 *Id. Cf. Pitchford v. Oakwood Mobile Homes, Inc.*, 124 F. Supp.2d 958, 964-65 (W.D.Va. 2000) (magistrate evaluated the fees and cost schedule in the arbitration schedule and recommended invalidating the clause as unconscionable; district court judge actually invalidated the arbitration clause on the basis that it was precluded by the Magnuson-Moss Act, 15 U.S.C. § 231: "there can be no agreement at the time of sale to enter in binding arbitration on a written warranty.")
28 167 F. Supp.2d at 897.
29 *Id.* at *1.
30 *Id.* at *2.
31 *Id.* at *4.
32 *Id.*
33 *Id.*
34 *Id.* at *5.
35 *Id.* at 304.
36 *Id.*
37 *Id.*
38 *Id.*
39 *Sydnor,* 252 F.3d at 305.
40 *Sydnor,* 252 F.3d at 306 (citing *Hooters,* 173 F.3d at 940).
41 *Id.* (citing *Randolph,* 531 U.S. at 92).
42 *Id.* at 306.
43 *Id.*
44 *Id.*
45 *Id.* at *2 - *3.
46 *Id.* at *3. *See also Randolph,* 531 U.S. at 96 (Ginsburg, J., concurring) (discussing the inequitable bargaining power between consumers and financial institutions)