Arbitrating Federal Antitrust Claims, Class Action Waivers, and the "Effective Vindication" Doctrine

CASE AT A GLANCE

The respondent retail merchants entered into agreements with petitioner American Express (Amex) detailing how the respondents would accept Amex's credit and charge cards. Respondents brought a Sherman Antitrust Act lawsuit against Amex, claiming that Amex used its monopoly power to force merchants to accept the agreement. Amex responded that the agreement requires arbitration, but prohibits classwide arbitration. The Court must now determine the effect in a federal Sherman Antitrust Act action of an arbitration clause that prohibits classwide arbitration, but where enforcement of the arbitration clause would effectively prevent the plaintiffs from vindicating their rights in the arbitral forum.

American Express Co. v. Italian Colors Restaurant
Docket No. 12-133

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From: The Second Circuit

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ISSUE

May a federal court invalidate an arbitration agreement that a defendant invokes to resolve a Sherman Antitrust Act claim when the arbitration agreement does not permit class arbitration, but where the litigant has shown that it would be unable to effectively vindicate its federal statutory rights to prosecute the antitrust claim in the arbitral forum?

FACTS

This appeal represents the third time in three years that the Supreme Court will consider the nature and scope of an arbitration agreement that contains a class action waiver—that is, a provision that does not permit an arbitration to be resolved on a classwide basis. In spite of this, the plaintiffs below (the respondents on appeal) contend that this case does not concern classwide arbitration at all, and that the classwide arbitration issue is a red herring.

Nonetheless, this appeal is interesting because the litigants have been whipsawed by the Court's two previous arbitration decisions, resulting in remands and three appellate decisions labeled *Amex I, Amex II,* and *Amex III.* Although the defendant American Express (Amex) originally prevailed in the district court, it has now lost its arguments three times before the Second Circuit.

The Italian Colors Restaurant and other retail merchants entered into an "Honor All Cards" agreement with Amex. Amex issues two types of cards. A "charge card" requires the consumer to pay the outstanding balance at the end of a standard billing cycle. A "credit card," on the other hand, allows the cardholder to pay a portion of the amount owed at the close of a billing cycle, subject to interest charges. Credit cards, then, offer an enhanced opportunity to profit from consumer interest charges, with a relative disincentive to accept charge cards.

Retail merchants who wished to offer consumers the option of payment through Amex were required to agree to an "Honor All Cards" policy: that is, they had to agree to accept Amex charge cards as well as its credit cards. Italian Color Restaurant and other merchants filed a lawsuit in the Southern District of New York, alleging that Amex's "Honor All Cards" policy constituted an unlawful tying agreement under §1 of the Sherman Antitrust Act, 15 U.S.C. § 1 et seq. They allege that Amex has monopoly power which forced merchants to accept ordinary credit cards at rates 30 percent higher than the fees for identical bank-issued cards in competing networks, such as Visa and MasterCard.

In order to prove their tying claims, the plaintiffs would have to define the relevant market, prove Amex's market power, prove that Amex used its market power in furtherance of its tying scheme, prove the anticompetitive effects, and calculate damages.

Each merchant entered into a "Card Acceptance Agreement" with Amex that included an arbitration provision requiring bilateral rather than classwide arbitration: that is, arbitration between one plaintiff (a retailer) and one defendant (Amex). After the merchants sued, Amex moved to compel arbitration. However, the plaintiffs resisted, arguing that the arbitration clause precluded them from effectively vindicating their federal statutory rights under the Sherman Antitrust Act in the arbitral forum. In particular, the plaintiffs

argued that the small individual amount of each plaintiff's claim rendered arbitration cost-prohibitive because they could not prosecute their tying claim without at least one detailed antitrust market study.

The plaintiffs presented the district court with expert witness testimony showing that the cost of obtaining the necessary antitrust market study was between $300,000 and $1,000,000, an amount that greatly exceeded the potential median damages of $5,252 for individual plaintiffs. Arguing that such cost was prohibitive, the plaintiffs concluded that they were effectively prevented from vindicating their federal statutory rights in arbitration—invoking the so-called effective vindication doctrine. Nonetheless, the district court granted the defendant's motion to compel arbitration and dismissed the plaintiffs' lawsuits, rejecting the plaintiffs' "prohibitive costs" and effective vindication arguments.

In the plaintiffs' first appeal, the Second Circuit reversed. (*Amex I,* 554 F.3d 300). The court held that the arbitration agreement was invalid under the "federal substantive law of arbitrability"—the judicial decisions interpreting the Federal Arbitration Act (FAA). 9 U.S.C. § 2. The court concluded that the existence of large and prohibitive arbitration costs could preclude a litigant from effectively vindicating her statutory rights in the arbitral forum. The Second Circuit held that the courts were the appropriate tribunal to decide the effective vindication question, and that, here, the plaintiffs had met their heavy burden of showing that prohibitive costs would prevent the plaintiffs from effectuating their statutory claims. The court invalidated the class action waiver and remanded the matter to the district court to allow Amex to withdraw its motion to compel arbitration.

While Amex's appeal of that decision was pending on the Court's docket, the Supreme Court decided *Stolt-Nielsen S.A. v. AnimalFeeds International Corp.,* 130 S. Ct. 1758 (2010). In *Stolt-Nielsen,* the Court vacated an arbitration award, concluding that a party could not be compelled under the FAA to submit to class arbitration unless there was a contractual basis for concluding that the party agreed to do so. The Court also rejected the plaintiff's argument that classwide arbitration was necessary because of the plaintiff's "negative value claims"—that is, small value claims. In light of its decision in *Stolt-Nielsen,* the Court granted certiorari in Amex's appeal, vacated the Second Circuit's decision in *Amex I,* and remanded for further consideration in light of the *Stolt-Nielsen* decision.

On remand in *Amex II* (634 F.3d at 187), the Second Circuit panel again refused to enforce the parties' arbitration agreement, concluding that nothing in *Stolt-Nielsen* altered the outcome of its prior decision. The court held that *Stolt-Nielsen* did not bar a court from using public policy to find contractual language in an arbitration agreement void. The Second Circuit went even further, holding that its *Amex I* decision needed to be broadened to invalidate the parties' arbitration agreement entirely. Justice Sotomayor was a member of this panel, before her elevation to the Supreme Court.

Amex again appealed to the Supreme Court. While this appeal was pending, the Court decided *AT&T Mobility LLC v. Concepcion,* 131 S. Ct. 1740 (2011), holding that the FAA preempted California's so-called *Discover Bank* rule, which was applied to find unconscionable those arbitration agreements that did not permit classwide arbitration. See *Discover Bank v. Superior Court,* 113 P.3d 1100 (Cal. 2005). The Court also rejected the argument that plaintiffs with small claims who face prohibitive costs in arbitration could justify a court requiring classwide arbitration procedures as a condition to enforcing an arbitration agreement.

In light of *Concepcion,* the Second Circuit *sua sponte* granted a rehearing to consider its impact. In *Amex III* (667 F.3d at 204), decided on February 1, 2012, the court concluded that *Concepcion* did not alter its analysis. The court noted that *Stolt-Nielsen* and *Concepcion* stood for the principle that parties cannot be forced to arbitrate disputes in classwide arbitration. The court further concluded that those decisions did not foreclose courts from invalidating arbitration agreements that did not include a class arbitration provision, and that neither *Stolt-Nielsen* nor *Concepcion* undermined the effective vindication rule.

And, for the third time, the Second Circuit held that arbitration agreements providing for bilateral (but not classwide) arbitration were unenforceable if the claimant could demonstrate that the cost of individually arbitrating their dispute would be prohibitive. Based on the record in the district court, the court "declined to strip the plaintiffs of rights accorded to them by statute" by compelling an arbitration that would never occur due to prohibitive costs.

On May 29, 2012, the Second Circuit denied a rehearing en banc over the dissenting votes of five judges. This denial paved the way for the Court granting certiorari to hear Amex's appeal, again.

CASE ANALYSIS

This term the Court returns its focus to arbitration agreements under the FAA, although the respondents steadfastly argue that the case does not implicate classwide arbitration. In modern commercial agreements governing parties' rights and obligations, parties routinely include arbitration provisions. The FAA governs this alternative dispute resolution mechanism. When a contract dispute arises and parties initiate litigation, one party (usually a defendant) may invoke the arbitration clause in order to resolve the disagreement outside the judicial arena. Once an arbitration clause is invoked, the arbitrator has wide latitude in interpreting the provisions. However, when disagreements arise over the contractual interpretation of a provision, the disputing parties may turn to the courts to resolve these differences.

After several decades of disfavoring arbitration provisions, courts eventually started to embrace a doctrine that favors arbitral agreements and the resolution of disputes outside the court system. In a series of decisions, the Court has read the FAA broadly to require enforcement of arbitration agreements in accordance with the terms of the agreement. Moreover, although courts historically resisted arbitration of federal statutory claims, federal courts now recognize that federal claims (including antirust claims) can be resolved through arbitration.

Until fairly recently, almost all arbitration provisions were bilateral contracts between two parties to resolve future disputes through arbitration auspices. However, in the past decade defendants invoking arbitration clauses have been confronted by plaintiffs seeking classwide arbitration as a means to resolve not only their individual claim, but claims of all other similarly situated persons. Thus, courts

have had to grapple with a series of cases construing arbitration provisions that contain no language referring to the possibility of classwide arbitration, or provisions that explicitly forbade classwide arbitration. Arbitration clauses expressly eschewing classwide arbitration are referred to as containing "classwide arbitration waivers."

The Court's first classwide arbitration case concerned a plaintiff who sought to pursue classwide arbitration where the contractual arbitration clause was completely silent on the issue. The defendant had drafted a standard arbitration clause suitable for typical bilateral disputes, without anticipating that a plaintiff might seek classwide arbitration of all other similar claims. The Court held that where an arbitration clause was silent concerning whether an arbitrator might conduct classwide arbitration, the decision to conduct classwide arbitration rested with the arbitrator. See *Green Tree Financial Corp., Alabama v. Randolph,* 531 U.S. 79 (2000).

Randolph also set forth the "effective vindication" rule, which indicated that where a plaintiff's costs entailed in prosecuting a claim through arbitration were so prohibitive as to effectively prevent vindication of rights, then the arbitration clause was unenforceable. On the facts in *Randolph,* the Court found that the plaintiff had not made a showing of prohibitive costs.

In the intervening decade, and in the wake of the Court's somewhat surprising *Randolph* ruling, corporations drafted arbitration agreements to insulate themselves from potential classwide arbitration by including specific class action waivers in their arbitration provisions. Defendants invoked these so-called class action waivers in both state and federal court to fend off classwide arbitration. Finally, in *Stolt-Nielsen,* the Court held that the FAA prohibited arbitrators from imposing classwide arbitration on parties who had not previously consented to it.

As class action waiver provisions became prevalent in arbitration clauses, California state courts led the country in articulating a doctrine of contract unconscionability to test the enforceability of class action waivers. In 2005, the California Supreme Court codified this test in the "*Discover Bank* rule." See *Discover Bank v. Superior Court*. Pursuant to this doctrine, California courts could find class action waivers invalid if (1) the waiver was found in a consumer contract of adhesion, (2) the dispute between the parties predictably involved small amounts of damages, and (3) the plaintiff alleged a scheme to deliberately cheat large numbers of consumers out of individually small sums of money. Applying the *Discover Bank* rule, several California state courts invalidated class action waivers in consumer contracts, finding the contracts unconscionable because they did not permit classwide arbitration.

In 2011, the U.S. Supreme Court heard an appeal on the legitimacy of the *Discovery Bank* rule. In its third major classwide arbitration case, the Court held that the FAA preempted California's *Discover Bank* rule. *AT&T Mobility LLC v. Concepcion*. In so doing, the majority went out of its way to affirm its support for the FAA, which provides that arbitration agreements "shall be valid, irrevocable, and enforceable, save upon such grounds as exist at law or in equity for the revocation of any contract." 9 U.S.C. § 2. Thus, the Court reiterated that this provision reflects a federal policy favoring arbitration and the fundamental principle that arbitration is a matter of contract law.

In *Concepcion,* the Court held that although § 2 of the FAA preserves generally applicable contract defenses (such as unconscionability), "Nothing in it suggests an intent to preserve state law rules that stand as an obstacle to the FAA's objectives." Construing FAA §§ 2, 3, and 4, the Court held that the overarching purpose of the act was to ensure enforcement of arbitration agreements according to their terms so as to facilitate streamlined proceedings. Measured against this core purpose, then, "requiring the availability of classwide arbitration interferes with the fundamental attributes of arbitration and thus creates a scheme inconsistent with the FAA."

Much of the Court's *Concepcion* opinion was devoted to explaining why classwide arbitration interfered with the purpose of arbitration. The Court pointed out that shifting from a bilateral arbitration proceeding to classwide arbitration radically altered important structural matters, including the consideration of absent class members necessitating additional different procedures. The Court suggested that arbitrators generally are unfamiliar with dominant class certification requirements, including the protection of absent class members. The Court indicated that it doubted that Congress, in enacting the FAA in 1925, ever contemplated leaving the disposition of class action requirements to an arbitrator.

Thus, the Court concluded that authorization of classwide arbitration sacrificed the principal advantages of arbitration: informality, speed, and cost-effectiveness. According to the Court, approving classwide arbitration made the dispute resolution process slower, more costly, and "more likely to generate [a] procedural morass than final judgment." Finally, the Court noted that sanctioning classwide arbitration placed defendants at increased risks, creating an "in terrorem" pressure upon defendants to settle questionable claims.

The majority concluded that because California's *Discover Bank* rule "stands as an obstacle to the accomplishment and execution of the full purposes and objectives of Congress," the FAA preempted this state law rule.

This appeal, then, is the fourth arbitration case before the Court in recent years. In this instance, the respondent-retail merchants believe that the Second Circuit's two decisions after *Stolt-Nielsen* and *Concepcion* were correct in applying *Randolph's* effective vindication rule. In spite of *Stolt-Nielsen* and *Concepcion,* the Second Circuit held that to require arbitration (1) would effectively deny the plaintiffs the opportunity to vindicate their federal statutory rights under the Sherman Antitrust Act in the arbitral forum, and (2) would effectively preclude the claimants with small individual claims from seeking justice because of the prohibitive costs.

On appeal, Amex argues that *Stolt-Nielsen* and *Concepcion* are dispositive of this case, and that the Second Circuit was not authorized to override the parties' choice of a bilateral, rather than classwide, arbitration. Amex contends that the history of the Sherman and Clayton Antitrust Acts demonstrates that Congress never intended to permit classwide procedures for antitrust claims, even for modest value claims. In addition, Amex notes the concept of classwide arbitration did not exist when Congress enacted the FAA in 1925.

Moreover, Amex maintains that Concepcion forecloses the "prohibitive cost" and "vindication of statutory rights" rationales the Second

Circuit adopted, and urged by the respondents. They argue that *Randolph's* references to prohibitive costs and the effective vindication rule are mere dicta. According to Amex, the rationales detailed for these docrtrines are indistinguishable from the California Supreme Court's reasoning in *Discover Bank,* which the Court rejected in Concepcion. Furthermore, *Concepcion* held that the FAA preempted the *Discover Bank* rule in all cases, and therefore that decision cannot be limited only to cases involving state law claims.

Finally, Amex argues that the Second Circuit erred in imposing its own pro-class action policy judgments rather than following Congress's FAA mandate to enforce the parties' agreement to conduct bilateral arbitration. In so doing, Amex asserts, the Second Circuit ignored the benefits of resolving disputes through bilateral arbitration, focused exclusively on the perceived policy benefits of class proceedings, and ignored serious policy disadvantage.

Respondents have framed the issue entirely different than Amex; respondents contend that the only issue centers on the appropriate application of the effective vindication rule. Respondents repeatedly assert that they are not seeking class arbitration and that the case is not about class arbitration or class action waivers. They contend that Amex's class arbitration contentions are red herring arguments.

Relying heavily on *Randolph,* respondents contend that the effective vindication rule is a narrow, well-established rule that is pro-arbitration and fully consonant with the underlying policies of the FAA. Respondents note that the effective vindication rule applies where enforcing an arbitration clause would impose prohibitive costs such that plaintiffs are unable to vindicate their federal statutory rights. According to respondents, plaintiffs carry a very high, daunting burden to demonstrate that such prohibitive costs would effectively prohibit the vindication of federal rights. Since *Randolph,* although most federal circuit courts have endorsed the effective vindication test, very few litigants have been able to prevail on this argument because the standard is so exacting.

Respondents argue that their case is the rare instance in which plaintiffs have carried that burden. They proved, through uncontested expert evidence offered to the district court, that they could not effectively prosecute their antitrust claim in arbitration because of the very high expense to retain an expert to produce a market study, relative to the potential low damage awards to each claimant. Moreover, respondent notes, Amex never offered to shift the costs of a market report to themselves, nor did Amex offer to stipulate to its market power or other similar antitrust issues that would have negated respondents' need to incur prohibitive costs to pursue their antirust claims.

Respondents further suggest that the central problem lies in the parties' arbitration agreement, which failed to include any ameliorating provisions relating to cost-shifting for expenses in prosecuting a complex antirust claim. Respondents repeatedly suggest that if Amex were willing to amend the arbitration provision to offer cost-shifting, agree to cover the costs of an expert market report, or stipulate to market power, then respondents would drop their opposition to the arbitration clause. They argue that if Amex wants to adopt a better arbitration agreement that allows cost-shifting for prevailing parties, then they stand ready to vindicate their federal antitrust claims through a bilateral arbitration. Respondents note that many corporations now draft arbitration clauses that contain such favorable cost-shifting mechanisms.

Moreover, respondents argue that their position does not conflict with the Court's recent *Stolt-Nielsen* and *Concepcion* decisions. They argue that nothing in those cases was intended to overrule *Randolph's* effective vindication rule, and that *Concepcion* was foremost a federal preemption case under the Supremacy Clause, and therefore irrelevant to this case. The effective vindication rule, in contrast, is a uniquely federal doctrine that reconciles the conflict between the FAA and the competing federal statutory right to prosecute an alleged antitrust violation. Finally, respondents contend that continued application of the effective vindication doctrine would not implicate floodgate concerns because so few litigants can meet the very high burden of showing actual prohibitive costs but rather creates healthy incentives to corporations to draft truly pro-arbitration agreements.

SIGNIFICANCE

Amex is significant because of the pervasiveness of arbitration provisions in modern commercial and consumer transactions, and the need for certainty in the interpretation and application of these provisions. Judicial reception to the use of arbitration as a means of alternative dispute resolution has shifted over time. Whereas courts once viewed such provisions with antipathy, courts now embrace the public policy doctrine favoring such private dispute resolution auspices. Nonetheless, this shift in appreciation for arbitration has occurred in a litigation landscape characterized by two-party disputes.

In the past decade, the emergence of classwide arbitration has taken contracting parties and the courts somewhat unaware. The prevalence of disputes over classwide arbitration, then, has exposed a challenging issue for ensuring certainty in dispute resolution. Moreover, fundamental public policy issues underlie the litigation over class action waivers in arbitration agreements. In addition, courts now recognize that the costs associated with certain types of complex litigation may effectively render arbitration impossible.

The Court's evolving arbitration jurisprudence has shaped corporate transactional behavior. Corporate defendants typically seek to insure against the unintended consequences of classwide arbitration by specifically prohibiting it through contractual language. However, as respondents point out, corporate defendants increasingly have included more nuanced provisions in arbitration clauses to make arbitration more attractive to potential plaintiffs. These additional provisions include such measures as cost-shifting and payment of filing and arbitration fees. On the other hand, plaintiffs seek to ensure access to arbitral justice by invoking unconscionability doctrines or the effective vindication rule.

On a number of occasions now, the Court has tried to provide guidance for the construction and application of arbitration clauses that either are silent with regard to classwide arbitration or that contain class action waivers. In its most recent venture, the Court in *Concepcion* rather thoroughly canvassed all arguments in favor of and opposition to the enforcement of class action waivers, albeit on review of a state Supreme Court decision. The *Amex* appeal recanvasses much the same arguments as in *Concepcion,* only in

the context of purported enforcement of federal antitrust statutes (rather than state law claims). It remains to be seen whether the different procedural posture makes a material difference for the Court's appreciation of class action waivers, or whether this appeal causes the Court to further qualify its *Randolph, Stolt-Nielsen,* and *Concepcion* decisions.

In addition to the class action waiver dispute, this appeal also offers the Court the opportunity to clarify the effective vindication rule and address that it was mere dicta in *Randolph* or an important consideration in the enforceability of arbitration clauses. The *Randolph* decision sets forth the effective vindication rule, adopted by many federal courts, and this appeal offers the Court an opportunity to revisit the scope of this doctrine.

Respondents argue that to compel arbitration in cases where the plaintiffs' costs are prohibitive would not actually lead to arbitration of their federal claims, but would rather grant Amex de facto immunity from federal antitrust law. The Court will have to consider whether this theory underlying the effective vindication rule merits the Court's endorsement.

Finally, because Justice Sotomayor sat on the Second Circuit panel that decided at least one Amex appeal, she is likely to recuse herself, leaving an eight-justice Court to decide this appeal.

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PREVIEW of United States Supreme Court Cases, pages 191–195.

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Tracking the Term*

43 – Number of oral arguments
10 – Number of cases (granted full review and oral argument) decided
17 – Days of oral argument remaining
75 – Number of cases granted to date

*As of February 11, 2013