Paying the Price of Process:
Judicial Regulation of Consumer Arbitration Agreements

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Arbitration clauses now appear in many of the form contracts through which consumers obtain goods, services and credit. Why do so many businesses that deal with consumers choose arbitration? Relative to litigation, arbitration provides opportunities for a business to save on its dispute-resolution costs. If arbitration does, in fact, lower these costs then arbitration lowers the prices (and interest rates) consumers pay because competition forces businesses to pass their cost-savings on to consumers.2

This pro-consumer aspect of arbitration is generally overlooked, and the enforceability of consumer arbitration agreements is often criticized. Not all consumer arbitration agreements are enforced. Courts regulate consumer arbitration by enforcing arbitration clauses that have certain features, while refusing to enforce

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2. See infra Part I.B.
5. See cases cited infra notes 36 & 40. See also Drahozal quote infra note 56. See generally STEPHEN J. WARE, ALTERNATIVE DISPUTE RESOLUTION §§ 2.25 & 2.28 (2001).
arbitration clauses that lack those features. This judicial regulation of arbitration agreements increases the dispute-resolution costs of the businesses with which consumers deal. And this cost-increase, in turn, raises the prices consumers pay. In short, judicial regulation of consumer arbitration agreements imposes costs on consumers. Whether such regulation yields any benefits that outweigh these costs is a complex and controversial question.

I. ARBITRATION CLAUSES LOWER PRICES

A. Assumption: Arbitration Clauses Lower Business’ Costs

Arbitration, like litigation, is a form of binding adjudication. The process of arbitration, however, can be very different from the process of litigation. These differences can make arbitration attractive to businesses that deal with consumers. Relative to litigation, arbitration provides opportunities for such a business to save on its dispute-resolution costs.

First, arbitration does away with juries and, for that reason, is commonly thought to reduce the likelihood of high damages awards against businesses. Second, arbitration’s confidentiality “lessens the risk of adverse publicity” about a business and its disputes. Third, arbitration can resolve disputes “according to a nationally uniform set of procedures,” thus saving interstate businesses the costs of adapting to different procedural rules in different states. Fourth, arbitration’s finality (near absence of appellate review) saves businesses the costs of appeals. Fifth, arbitration can eliminate the possibility of class actions against businesses. Sixth, arbitration can deter claims against businesses by requiring consumer-plaintiffs to pay arbitrator fees, as well as filing fees that exceed the filing fees in litigation. Seventh, arbitration can reduce the amount of discovery available to consumer-plaintiffs, thus

6. Those features are identified and discussed infra Part II.
7. See infra Part III.
8. See Ware supra note 5, § 1.6(c).
10. For those who represent large companies, arbitration is also seen as an opportunity to avoid the unpredictability of juries. Arbitrators are generally viewed as more likely to render awards that bear a reasonable relationship to actual damages incurred, although large awards for noneconomic injury, as well as punitive damage awards, are not unheard of in arbitration.
12. Kaplan & Levin, supra note 9, at 845.
13. Id.
14. Id. See Ware, supra note 5, § 2.43 (courts rarely vacate arbitration awards).
15. See infra Part II.A.
16. See infra Part II.B.
reducing the amount of time and money businesses must spend on the discovery process and also making it harder for consumers to prove their claims.\textsuperscript{15}

The foregoing is a list of just some of the reasons why arbitration might enable a business to save on its dispute-resolution costs. And these reasons have apparently led a number of businesses to include arbitration clauses in their consumer contracts.\textsuperscript{16} There is not, however, any publicly-available study indicating whether arbitration clauses have in fact saved businesses money. A business using consumer arbitration agreements could study the effects of those agreements on the business’ bottom line,\textsuperscript{17} and it seems likely that some such businesses have done so. Nevertheless, research revealed no publicly-available studies of that sort. So this article will proceed on an assumption. The assumption, customary in economics, is that businesses generally act in their own interests, i.e., are “profit-maximizing.”\textsuperscript{18} This article will assume that those businesses that use consumer arbitration agreements are doing so because those businesses find that they benefit from those agreements, i.e., that those agreements lower their dispute-resolution costs.\textsuperscript{19}

\textbf{B. Competition Forces Businesses to Pass on Cost-Savings to Consumers}

Assuming that consumer arbitration agreements lower the dispute-resolution costs of businesses that use them, competition will (over time) force these businesses to pass their cost-savings to consumers.\textsuperscript{20} This pass-on follows from a basic principle of economics, the \textit{rate-of-return equalization principle}. As a standard economics text explains:

\begin{quote}
If the market price of a good is greater than the opportunity cost of producing it, suppliers will gain from an expansion in production. Profit-seeking entrepreneurs will be attracted to the industry. Investment capital will flow into the industry, and output (supply) will expand until the additional supply lowers the market price sufficiently to eliminate the profits. In contrast, if the market price is less than the good’s opportunity cost of production, suppliers will lose money if they continue to produce the good. The losses will drive producers from the market and capital will flow away from the industry. Eventually the decline in supply and
\end{quote}

\textsuperscript{15} \textit{See infra} Part II.C.
\textsuperscript{16} \textit{See} KAPLINSKY \& LEVIN, supra note 9, at 845-48.
\textsuperscript{17} On the methodological issues surrounding such a study, see Ware, \textit{Effects of Gilmer, supra note 1.}
\textsuperscript{18} \textit{See} JAMES D. GWARTNEY \& RICHARD L. STROUP, ECONOMICS: PRIVATE AND PUBLIC CHOICE 532-39, 563-65 \& 595-98 (7th ed. 1995) (profit-maximizing firms produce additional output so long as the marginal revenue of doing so exceeds the marginal cost).
\textsuperscript{19} It is possible that businesses using arbitration agreements are acting against their own interests by doing so. Similarly, it is possible that businesses that choose not to use arbitration agreements are acting against their own interests. Given the variety of businesses and their situations, it seems likely that consumer arbitration agreements are in the interests of some businesses, but not others.
\textsuperscript{20} The pass-on can be in the form of lower prices or some other change favoring consumers, such as a more generous warranty.
shrinkage in the capital base (durable productive assets) of the industry will push prices upward and eliminate the losses.

In a market economy, characterized by freedom of entry and exit, there will be a tendency for the after-tax rate of return on investment to move toward a uniform rate, the competitive or normal-profit return. Neither abnormally high nor abnormally low after-tax returns will persist for long periods of time. This tendency for returns on investment capital to move toward a uniform, normal rate is sometimes referred to as the rate-of-return equalization principle. 21

The rate-of-return equalization principle implies that whatever increases an industry’s profits ultimately attracts additional capital to that industry, causing an increase in that industry’s output and therefore a reduction in its price. Suppose, for example, that firms in the widget industry add arbitration clauses to their consumer contracts and that this causes a reduction in these firms’ dispute-resolution costs and a corresponding increase in their profits. These above-normal profits will attract additional capital to the widget industry, causing an increase in the supply of widgets and therefore a reduction in the price of widgets.

Importantly, this process occurs regardless of whether consumers understand, or even notice, the arbitration clauses. 22 This process works to lower prices because investors and entrepreneurs are alert to above-normal profits, not because consumers are alert to the arbitration clauses which cause those profits. 23 The increase in output attracted by above-normal profits is what lowers prices. In other words, the fact that widget-buying consumers get arbitration clauses is what causes them to also get lower prices. This is an example of the general insight that contract terms favorable to sellers go hand-in-hand with lower prices. Recognition of this has been standard in the law-and-economics literature for at least a quarter of a century. 24

The law-and-economics literature features debate about the existence of, and proper response to, the problem of imperfect information causing unregulated form contract terms to be too harsh to the consumer with respect to terms about which consumers are often ignorant and (therefore) too favorable to the consumer with respect to those terms, such as price, about which consumers are typically knowledgeable. 25 Some articles opposing enforcement of consumer arbitration

22. Ware, supra note 3, at 212 n.95.
23. For this reason, one must be careful about assertions that “the competitive defense of form contracts depends on an assumption that consumers read, understand, and evaluate the cost of the binding arbitration clause being imposed by the seller.” Sternlight, supra note 4, at 688. If the “competitive defense” refers to the contention that “benefits secured by [sellers] through imposition of an arbitration provision will be passed on to the consumers,” Id. at 687, then the competitive defense, as explained in the text, does not depend on an assumption that consumers read or understand the arbitration clause.
agreements cite this law-and-economics debate. These articles can be read as asserting that imperfect information causes consumer arbitration agreements to be too harsh to the consumer with respect to the arbitration clause and too favorable to the consumer with respect to price. These articles, however, lack an explicit acknowledgment that harsh terms yield lower prices. So these articles may reflect a belief that price-reductions occur only when consumers “read, understand, and evaluate” the arbitration clause. To reiterate, that belief clashes with the reasoning of this article’s previous few paragraphs.

Those paragraphs began with the plausible assumption that enforceable consumer arbitration agreements lower the dispute-resolution costs of businesses that choose to use such agreements. These cost-savings lead, through competition among businesses for capital, to lower prices for consumers. The greater the cost-savings to business, the greater the price reduction for consumers. To put it another way, the more costly arbitration is to business, the more consumers pay for goods, services and credit. When arbitration law changes in a way that makes arbitration more costly to business, then arbitration law is raising prices paid by consumers. Attempts to make arbitration more favorable (or “fair”) to consumers have a downside for consumers if the effect of those attempts is to raise businesses’ arbitration costs.

The following section discusses recent judicial decisions likely to make arbitration more costly to business. To the extent these cases have that effect, they can be known as “price-raising cases” or simply “price-raisers.”

II. PRICE-RAISING CASES

A. Requiring Class Actions
First among the price-raisers are cases holding that arbitration agreements must allow for class actions. Businesses can incur substantial liability in consumer class actions, both in cases that provide significant relief to the class and in cases that provide insignificant relief to the class but significant fees to plaintiffs’ lawyers. Limiting consumer claims to individual actions would deter some of those claims that plaintiffs’ lawyers find worth pursuing as part of a class action, but not as an individual action. Accordingly, some businesses use arbitration clauses in the hope that courts will enforce these clauses to preclude class actions. And many cases have done just that. Other cases, by contrast, have certified classwide arbitration or allowed classwide litigation to proceed notwithstanding the arbitration clause.


32. A few of these claims would not be deterred because the consumer would pursue the claim pro se, i.e., without a lawyer.


This issue is complicated in the securities arbitration context by a National Association of Securities Dealers rule. See, e.g., Champ v. Siegel Trading Co., Inc., 55 F.3d 269 (7th Cir. 1995); Nielsen v. Piper, Jaffray & Hopwood, Inc., 66 F.3d 145 (7th Cir. 1995); In re Nasdaq Market-Makers Antitrust Litigation, 169 F.R.D. 493 (S.D.N.Y. 1996). See also Sternlight, supra note 33, at 110 ("Thus far, while experiences with class action arbitration are scant, participants in the few classwide arbitrations that have been held have not voiced sharp criticism of the inefficiency of such arbitrations."). See generally IAN R. MACNEIL, RICHARD E. SPEDIEL & THOMAS J. STEFANOWICH, FEDERAL ARBITRATION LAW § 18.9 (1994 & Supp. 1996).

35. Blue Cross of California v. Superior Court, 78 Cal. Rptr. 2d 779, 785 (Cal. Ct. App. 1999); Lewis v. Prudential Bache Secs., Inc., 225 Cal. Rptr. 69 (Cal. Ct. App. 1986); Izzi v. Mesquite Country Club, 231 Cal. Rptr. 315 (Cal. Ct. App. 1986). See also Sternlight, supra note 33, at 110 ("Thus far, while experiences with class action arbitration are scant, participants in the few classwide arbitrations that have been held have not voiced sharp criticism of the inefficiency of such arbitrations.").

36. See Lozada v. Dale Baker Oldsmobile, Inc., 91 F. Supp. 2d 1087, 1105-06 (W.D. Mich. 2000) (finding an arbitration provision is unconscionable in part because it waives class remedies allowable under Truth in Lending Act ("TILA"), as well as certain declaratory and injunctive relief under federal and state consumer protection laws); Ramirez v. Circuit City Stores, 90 Cal. Rptr. 2d 916, 920-21 (Cal. Ct. App. 1999) (finding arbitration clause in contract of employment voided as unconscionable, in part, because it would deprive arbitrator of authority to hear classwide claim), review granted and opinion superseded, 995 P.2d 137 (Cal. 2000); Powertel v. Bexley, 743 So. 2d 570, 577 (Fla. Ct. App. 1999) (refusing to enforce arbitration clause as unconscionable in part because of its retroactive application to preexisting lawsuit and because one factor as to its substantive unconscionability was that it precluded the possibility of classwide relief).

The Supreme Court recently declined to address (because it was not properly raised in the lower courts) a consumer’s argument that her arbitration agreement was unenforceable because it precludes pursuit of
These cases, by requiring that arbitration preserve the class action, raise the cost of arbitration to businesses and, therefore, raise prices to consumers.
While litigation is subsidized by the taxpayer, the parties must pay the full costs of arbitration. It has long been customary in arbitration for the claimant to pay the filing fee charged by the arbitration organization and for the parties to pay equal shares of the arbitrator’s fee. Recent employment arbitration cases, however, have refused to enforce agreements requiring the employee-claimant to pay fees according to this custom. These cases effectively require the business to subsidize the arbitration claim against it. Some employment cases go so far as to require the business to pay all or nearly all of the costs of arbitration. Several lower courts have moved toward this approach in the consumer arbitration context.

The Supreme Court addressed this topic in a recent Truth in Lending Act case, *Green Tree Financial Corp. v. Randolph*. The Court said that “the existence of large arbitration costs could preclude a litigant . . . from effectively vindicating her...
federal statutory rights in the arbitral forum,”42 and this would presumably make the arbitration clause unenforceable. But the Randolph Court placed the burden of showing prohibitively high fees on the consumer:

[W]here, as here, a party seeks to invalidate an arbitration agreement on the ground that arbitration would be prohibitively expensive, that party bears the burden of showing the likelihood of incurring such costs. Randolph did not meet that burden. How detailed the showing of prohibitive expense must be before the party seeking arbitration must come forward with contrary evidence is a matter we need not discuss; for in this case neither during discovery nor when the case was presented on the merits was there any timely showing at all on the point. The Court of Appeals therefore erred in deciding that the arbitration agreement's silence with respect to costs and fees rendered it unenforceable.43

Justice Ginsburg’s dissent in Randolph pointed out that “[a]s a repeat player in the arbitration required by its form contract, Green Tree has superior information about the cost to consumers of pursuing arbitration.” 44 The dissent added: “In these circumstances, it is hardly clear that Randolph should bear the burden of demonstrating up front the arbitral forum's inaccessibility, or that she should be required to submit to arbitration without knowing how much it will cost her.” 45 The dissent “would remand for clarification of Green Tree's practice” (if any) of subsidizing the arbitration costs of its consumer-claimants.46

Case law requiring a business to subsidize a consumer’s arbitration claim would raise prices in two respects. First, it would make arbitration more costly to businesses by making businesses pay more in fees for each case. Second, it would make arbitration more costly to businesses by increasing the number of cases brought at all. It would do this by lowering the financial barrier to asserting a claim.

C. Requiring Substantial Discovery

"Limitations on discovery, particularly judicially initiated discovery, remain one of the hallmarks of American commercial arbitration.”45 An important employment
arbitration case, however, indicates that arbitration agreements should not be enforced unless they provide for "more than minimal discovery." And there are a few cases refusing to enforce employees' arbitration agreements because of, among other things, the courts' concerns about insufficient discovery.

It is not clear whether these precedents will be extended to consumer arbitration or whether they require as much discovery as litigation has. If they require litigation-like discovery, they would raise the cost of arbitration to businesses and therefore raise prices to consumers. Litigation-like discovery would both increase the amount of time and money the business must spend on the discovery process and make it easier for consumers to prove their claims.

D. Prohibiting Carve-Outs

Some arbitration agreements require arbitration of the consumer's claims but permit the business to bring its claims in court. For example, some consumer credit agreements require arbitration of all claims except for: (1) collection actions; and (2) actions to preserve, repossess or foreclose on collateral. These two "carve-outs" encompass nearly all the claims lenders assert against consumer-borrowers.

48. Cole, 105 F.3d at 1482. See also Armendariz, 99 Cal. Rptr. 2d at 750 (agreement to arbitrate employment discrimination claims enforceable if "the arbitration [meets] certain minimum requirements, including neutrality of the arbitrator, the provision of adequate discovery, a written decision that will permit a limited form of judicial review, and limitations on the costs of arbitration").

49. See Kinney v. United Health Care Servs., Inc., 83 Cal. Rptr. 2d 348, 354-55 (Cal. Ct. App. 1999) ("The unconscionable nature of the unilateral arbitral obligation is heightened by certain other terms of United's arbitration policy. Given that United is presumably in possession of the vast majority of evidence that would be relevant to employment-related claims against it, the limitations on discovery, although equally applicable to both parties, work to curtail the employee's ability to substantiate any claim against United."); Gonzalez v. Hughes Aircraft Employees Fed. Credit Union, 83 Cal. Rptr. 2d 763, 766-67 (Cal. Ct. App. 1999), review granted and opinion superseded, 978 P.2d 1 (Cal. 1999); Hooters of America Inc. v. Phillips, 39 F. Supp. 2d 582, 614-15 (D.S.C. 1998) (arbitration held unconscionable in part because procedural rules were biased against employee and in favor of company where company had total control over selection of arbitrators, employee had severely limited discovery, and witness disclosure and sequestration were one-sided), aff'd on other grounds, 173 F.3d 933 (4th Cir. 1999) (holding employer had breached arbitration agreement by issuing biased rules).

50. See Jean R. Sternlight, Drafting a "Bulletproof" Consumer Arbitration Agreement: Is It Possible?, in ARBITRATION OF CONSUMER FINANCIAL SERVICES DISPUTES, 763, 790 (1999) (courts "are likely to strike down clauses which . . . deny the consumer access to discovery which is necessary in order for the consumer to have a chance of prevailing").

51. Paul H. Haagen, New Wineskins for New Wine: The Need to Encourage Fairness in Mandatory Arbitration, 40 ARIZ. L. REV. 1039, 1053 ("More restrictive discovery may leave a plaintiff with a meritorious claim unable to prove it."); Jean R. Sternlight, Rethinking the Constitutionality of the Supreme Court's Preference for Binding Arbitration: A Fresh Assessment of Jury Trial, Separation of Powers, and Due Process Concerns, 72 TUL. L. REV. 1, 89-90 (1997) ("Where, for example, one party has substantially greater access to relevant witnesses and physical and documentary evidence, denying the other party any discovery will essentially deny them the opportunity to prevail in an arbitration.").

52. See, e.g., Lackey v. Green Tree Fin. Corp., 498 S.E.2d 898, 905 (S.C. Ct. App. 1998) ("Green Tree retained the option to use judicial or non-judicial relief to enforce a security agreement relating to the manufactured home, to enforce the monetary obligations secured by the manufactured home, or to foreclose on the manufactured home.").
A lender may find that these carve-outs save it money. Collection actions against consumers often result in default judgments, so the challenge for the lender-plaintiff is not winning judgments but collecting them from often insolvent or judgment-proof debtors. Also, collection actions against consumers nearly always involve small amounts of money. The combination of these two facts makes collections practice an assembly line in which large numbers of small claims are processed at a low cost per claim. Even a slight increase in the cost per claim can make a significantly higher percentage of debts effectively uncollectible. Arbitration of collection actions may increase the cost per claim because the lender must win an arbitration award and then get that award confirmed in court, rather than simply win a default judgment in court.

The carve-out relating to collateral also seems well-suited to saving the lender money. A court order is a preliminary step to repossessing collateral by a sheriff.
or to a judicial foreclosure sale of collateral.\textsuperscript{59} Arbitration of lenders’ claims relating to collateral would be an additional step the lender would have to take before going to court to get the necessary order.\textsuperscript{60}

Some courts have refused to enforce arbitration agreements with one or both of these carve-outs, in part because of the carve-outs.\textsuperscript{61} These courts do not purport to prohibit these carve-outs under all facts among all parties. But with respect to facts like those before them, these courts effectively require lenders to arbitrate collection actions and actions relating to collateral. By doing so, these cases make arbitration more costly to lenders. Therefore, these cases raise the interest rates consumers pay.

III. CONCLUSION: IS THE PRICE WORTH IT?

The previous section of this article discussed judicial decisions that raise prices (and interest rates) by requiring arbitration to: (1) allow for class actions, (2) subsidize the consumer’s fees, (3) include substantial discovery, and (4) encompass both parties’ claims. Whether these price increases are worth incurring, i.e., whether the judicial decisions are good policy, plainly depends on a number of factors including the amount of the price increase caused by each category of judicial decision. And different observers will certainly have different views about the value of, for example, class actions and litigation-like discovery. This article makes no attempt to assess the merits of those different views. Rather it argues that any such assessment should consider the influence consumer arbitration law has on the prices consumers pay.\textsuperscript{62} Failure to address price inevitably biases any assessment of


\textsuperscript{60} See Drahozal quote supra note 56.


\textsuperscript{62} Cf. Drahozal, \textit{supra} note 53 at 587-88.

I don’t think I can really tell you whether consumer arbitration agreements should be enforced or not. What I do think important to keep in mind is that courts that decide not to enforce arbitration agreements, for whatever reason, perhaps justifiably, can impose costs on the parties. Courts can’t just hold something unconscionable without consequences. Given that sophisticated parties find these arbitration agreements beneficial, it seems to me that there is evidence that they may be beneficial to unsophisticated parties as well. You should at least keep in mind that there may be costs to not enforcing them. The costs may be worth taking. It is not my place to tell you one way or the other, but there are costs there that need to be taken into account.

\textit{Id.}
consumer arbitration law. It is easy to insist upon “due process” in consumer arbitration, indeed “due process” is as widely-cherished as “mom and apple pie,” but the hard thinking begins when one asks who pays the price of process and how much they pay.