

Mandatory Arbitration Clauses in Payday Lending Loans: How the Federal Courts Protect Unfair Lending Practices in the Name of Anti-Protectionism

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I. INTRODUCTION

In the last twenty years, U.S. companies have begun to require consumers with little bargaining power to resolve disputes through private arbitration rather than in court.¹ In fact, one study estimates that the average American has unknowingly given up their constitutional rights to a public trial in up to one-third of their consumer transactions.² While proponents of mandatory arbitration say that consumers are provided with a cheaper and more efficient forum than litigation,³ many believe that mandatory arbitration “has given large firms the power to displace the judiciary from its role in enforcing common law claims and statutory rights.”⁴ Payday lending companies are one of the many U.S. industries that have taken advantage of the Supreme Court’s pro-arbitration stance to the detriment of the customers.⁵

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¹ Jean R. Sternlight, *Creeping Mandatory Arbitration: Is It Just?*, 57 STAN. L. REV. 1631, 1636 (2005).

² *Id.* at 1639.

³ *Id.* at 1633.

⁴ David S. Schwartz, *Enforcing Small Print to Protect Big Business: Employee and Consumer Rights Claims in an Age of Compelled Arbitration*, 1997 WIS. L. REV. 33, 36–37 (1997).

⁵ A victim’s story: Earl Milford puts up an artificial Christmas tree in the house he shares with his son, daughter-in-law, and two grandchildren. There is no money for presents because Milford is a victim of payday loan easy money. Every month, Milford travels thirty miles to the city of Gallup and pays sixteen payday lending businesses a total of \$1,500 to cover the interest on his loans. Because New Mexico does not require lenders to check if customers have borrowed money elsewhere, people like Milford are allowed to take out many loans at a time. Thus, the cycle of debt begins and continues until either financial discipline or bankruptcy occurs. Erik Eckholm, *Seductively Easy, Payday Loans Often Snowball*, N.Y. TIMES, Dec. 23, 2006, at A1.

Payday loan companies have recently come under scrutiny thanks to triple digit interest rates and strategic placement in impoverished neighborhoods.⁶ Payday lending businesses have been banned in eleven states,⁷ and as of October 1, 2007, many lenders in the United States, including payday loan businesses, may not charge more than a 36% interest rate to active duty military personnel or their families.⁸

Mandatory arbitration clauses buried in contracts, where consumers unknowingly or hastily sign away their right to traditional courtroom protections in the event of litigation, are part of the payday lending trap. Mandatory arbitration clauses in payday loan contracts should be ruled unconscionable by courts. Splits in jurisdictions and the nebulous legal theory of unconscionability make this argument more difficult than it should be for payday loan borrowers.

This note will explore the problems with mandatory arbitration clauses in payday loans and suggests that voluntary mediation would be more suited to payday lending disputes. Part II will explain the payday loan process.⁹ More specifically, it will describe how payday lending borrowers are trapped in a cycle of debt which payday lending businesses depend on for their profits.¹⁰ Why usury laws do not sufficiently protect payday loan consumers will be discussed in Part III.¹¹ Part IV analyzes how federal courts have upheld or denied mandatory arbitration clauses under the legal doctrine of unconscionability; argues that mandatory arbitration clauses in payday lending loans should be held unconscionable; and suggests federal legislative options to remedy the current payday lending loan predicament.¹² Part V will discuss class action suits, specifically the split in jurisdictions, as to whether class action waivers are unconscionable.¹³ Finally, Part VI makes public policy suggestions to protect payday lending consumers and designs a new mediation system for payday lending disputes.¹⁴

⁶ See *id.*

⁷ *Id.*

⁸ William M. Welch, *Law Caps Interest on "Payday Advances" To Servicemembers*, U.S.A. TODAY, Oct. 17, 2006, available at http://www.usatoday.com/news/washington/2006-10-17-paydayloans_x.htm.

⁹ See *infra* Part II.

¹⁰ See *infra* Part II.

¹¹ See *infra* Part III.

¹² See *infra* Part IV.

¹³ See *infra* Part V.

¹⁴ See *infra* Part VI.

II. THE PAYDAY LENDING PROCESS AND LOAN FLIPPING

In the early 1990s, the United States contained only 200 payday lending stores.¹⁵ Between 2000 and 2004, the number of stores more than doubled from 10,000 to 22,000, and that number is expected to double again in the next decade.¹⁶ The popularity of the payday lending process means that the industry loans up to \$40 billion every year to people who are not traditionally credit-worthy.¹⁷ Since the payday loan industry is expected to grow at such a rapid pace, it is important to understand both how the payday lending process works and one of its biggest problems—loan flipping.

A. *The Payday Lending Process*

Payday loans are short term loans for small amounts of money that have very high interest rates.¹⁸ The period of the loan is usually two weeks, which coincides with the borrower's paycheck.¹⁹ A borrower may also give the lender a post-dated check, which the lender defers presenting for cashing until a specified time frame has passed, generally fourteen days.²⁰ Payday loans are also referred to as "cash advance loans," "post-dated check loans," "check advance loans," "deferred deposit checks," or "delayed deposit checks."²¹

In a standard payday transaction, a borrower must present little more than a driver's license, a checkbook, and proof of steady income in order to be eligible for a cash advance, but no credit checks are performed.²² A borrower then writes a personal, post-dated check or authorizes a debit from a personal checking account in exchange for a cash advance.²³ The check or debit is made for the amount of the loan plus fees, which are usually \$33 for

¹⁵ Ronald J. Mann & Jim Hawkins, *Just Until Payday*, 54 UCLA L. REV. 855, 861 (2007).

¹⁶ *Id.*

¹⁷ *See id.*

¹⁸ Tara Shinnick, Annotation, *State Regulation of Payday Loans*, 29 A.L.R. 6th 461 (2007). For example, a \$200 two-week loan with a \$30 fee has an annual interest rate of almost 400%. Mann & Hawkins, *supra* note 15, at 857.

¹⁹ Mann & Hawkins, *supra* note 15, at 857.

²⁰ *Id.*

²¹ Truth in Lending, 12 C.F.R. § 226, Supp. I, 2(a)(14) (2008).

²² *See* Deena Reynolds, *A Look at Payday Loans and Current Regulation in Texas*, 8 TEX. TECH. ADMIN. L.J. 321, 323 (2007).

²³ *Id.*

every \$100 borrowed.²⁴ When the loan is made, the lender and the borrower know that the borrower may not have the money to repay the cash advance so the parties agree that the post-dated check will not be cashed or the personal checking account debited until a later date.²⁵ On the agreed upon date, the borrower will repay the advance, the lender will cash the check, or the borrower may defer ("flip") the loan.²⁶

B. Payday Lending Institutions Depend on Chronic Loan Flippers and the Cycle of Debt for Profits

Deferring the loan is referred to as "loan flipping" or "rolling over."²⁷ Loan flipping allows borrowers to extend their loans by rolling over the first loan into a new loan.²⁸ In order to flip the loan, a borrower is required to write out a check for a "flipping fee" plus the cost of the new loan where the flipping fee is generally much less than the amount owed on the loan.²⁹ For example, it costs \$66 to roll over a \$200 loan in Texas.³⁰ The old loan amount is then rolled into the new loan amount, the flipping fee is added, and interest is charged on the entire amount of the flipped loan and fees.³¹

Borrowers choose to flip loans because payday lending institutions require consumers to pay the full amount of the loan at the end of the loan term (a balloon payment) so no incremental payments or payment plans are allowed.³² Many customers cannot afford to pay back the full extent of the loan.³³ Left with the prospect of rolling over the loan for a minimal fee or criminal prosecution for writing a bad check, most payday loan borrowers choose to roll over their loan.³⁴ The roll over process is detrimental to the borrower because the fees owed increase dramatically every time the loan is flipped due to triple digit interest rates.³⁵ In fact, the standard payday borrower pays back \$793 for a \$325 loan, costing Americans nearly \$4.2

²⁴ *Id.* at 324.

²⁵ 12 C.F.R. § 226, Supp. I, 2(a)(14).

²⁶ *Id.*; see *infra* Part II.B.

²⁷ Reynolds, *supra* note 22, at 325.

²⁸ See *id.*

²⁹ See *id.*

³⁰ *Id.*

³¹ See *id.*

³² See *id.*

³³ See Reynolds, *supra* note 22, at 325.

³⁴ See *id.*

³⁵ See *id.* at 325–26.

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billion per year in excessive fees.³⁶ Nearly 90% of payday lending revenues are based on fees stripped from borrowers who have flipped loans and are trapped in a cycle of debt.³⁷

For example, Lisa Engelkins, a single mother working for \$8 an hour, is a typical case of how easy it is to become trapped in the loan flipping cycle of debt.³⁸ When finances were tough she went to Urgent Money Service Store, wrote a post-dated check for \$300, and left with \$255.³⁹ She delayed the hardship of paying the \$255 loan back by renewing her loan thirty-five times.⁴⁰ Every two weeks for seventeen months, Engelkins paid \$45 in fees on her original loan.⁴¹ “As soon as you get your first loan, you are trapped unless you know you will have the 300 extra dollars in the next two weeks,” she stated.⁴² In the end, Engelkins paid over \$1,254 in fees for the \$255 revolving cash loan.⁴³ She finally escaped the debt trap by withdrawing all funds from her checking account, allowing all of her checks to bounce, and dedicating two years to paying off the original \$255 loan.⁴⁴ Engelkins’ thirty-five-week loan roll over is not abnormal—the typical payday borrower will have an outstanding payment for thirty weeks.⁴⁵

While the payday loan industry claims that the cash advance is only for emergencies, statistics show that many people are enticed into a cycle of indebtedness and reuse of “quick fix” options.⁴⁶ In fact, the Center for Responsible Lending found that the one time, two week payday loan borrower was “virtually non-existent.”⁴⁷ Numerous studies have also shown

³⁶ Uriah King et al., *Financial Quicksand: Payday Lending Sinks Borrowers in Debt with \$4.2 Billion in Predatory Fees Every Year*, at 2 (Nov. 2006), available at http://www.responsiblelending.org/pdfs.rr012-financial_quicksand-1106.pdf.

³⁷ *Id.*

³⁸ Center for Responsible Lending, *Victims of Payday Lending: Looking for a Way Out: Lisa Engelkin's Story*, <http://www.responsiblelending.org/payday-lending/tools-resources/victims-1.html>. (last visited May 13, 2009).

³⁹ *Id.*

⁴⁰ *Id.*

⁴¹ *Id.*

⁴² *Id.*

⁴³ *Id.*

⁴⁴ Center for Responsible Lending, *supra* note 38.

⁴⁵ Richard J. Thomas, *Rolling Over Borrowers: Preventing Excessive Refinancing and Other Necessary Changes in the Payday Loan Industry*, 48 WM. & MARY L. REV. 2401, 2411 (2007).

⁴⁶ See Reynolds, *supra* note 22, at 326; Center for Responsible Lending, *supra* note 38.

⁴⁷ King et al., *supra* note 36, at 3 (stating that the report “found that only one percent of payday loans go to borrowers who take out one loan per year and walk away free and

that most of the payday loan industry's profits are made on repeat customers, with more than half of all customers taking out more than six loans a year in North Carolina⁴⁸ and the average payday loan customer in Colorado taking out 9.38 payday loans from the same vendor.⁴⁹ Clearly, payday lending establishments depend on consumers who are in need of long-term cash flow remedies and not temporary high-interest loans.⁵⁰

III. USURY LAWS FAIL TO PROTECT PAYDAY LENDING CONSUMERS

Many opponents of payday lending argue that the practice of charging triple digit interest rates on short-term loans is usury and suggest the strict application of usury laws to payday loan transactions.⁵¹ Other critics of the payday loan industry hold that a strict application of usury laws is not enough to ensure that consumers are treated fairly by payday lenders.⁵² This section will explain what usury laws are and why they are not the best solution to protecting consumers of payday loans.

clear after paying it off . . . ninety-one percent of payday loans go to borrowers with five or more loan transactions per year . . . the data show that payday loans are, in fact, designed to be renewed.”).

⁴⁸ Mark Flannery & Katherine Samolyk, *Payday Lending: Do the Costs Justify the Price?*, at 4–5, available at http://www.chicagofed.org/cedric/files/2005_conf_paper_session1_flannery.pdf (“[A] substantial subset of borrowers appear to use the [payday lending] product chronically . . . Our numbers confirm the prevalence of repeated use by a subset of customers: we find that fewer than half of a typical store’s customers take out six or fewer loans per year.”).

⁴⁹ Paul Chessin, *Borrowing From Peter To Pay Paul: A Statistical Analysis of Colorado’s Deferred Deposit Loan Act*, 83 DENV. U. L. REV. 387, 410 (2006) (arguing that “Colorado payday lenders derive the majority of their revenues from, and hence are economically dependent upon, the ‘repeat’ borrower.”). Chessin also notes that the average number of times a payday borrow in Colorado takes out a loan may actually be more than 9.38 times because the data does not account for loans taken out from more than one payday lender.

⁵⁰ Reynolds, *supra* note 22, at 326 (“Continual loan flipping reveals that payday loans may not be serving a customer’s short-term lending needs . . . The high number of times a borrower typically rolls over a loan is strong evidence that these loans are not being used for emergencies but rather for long-term needs.”).

⁵¹ Thomas, *supra* note 45, at 2418.

⁵² *Id.* at 2402.

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A. *Arguments For and Against Strict Usury Laws for Payday Lending Contracts*

Usury is the taking of more for the use of money than the law allows.⁵³ Usury laws protect against the oppression of debtors through excessive rates of interest charged by lenders.⁵⁴ There is no federal usury law, so each state has its own percentage rate that is considered *de facto* usury.⁵⁵ Generally, four elements are held to be crucial in order to constitute usury:

There must be a loan or forbearance; the loan must be of money or something circulating as money; it must be repayable absolutely and at all events; and something must be exacted for the use of the money in excess of and in addition to the interest allowed by law.⁵⁶

Some states require an intent element on behalf of the lender to exact interest at a rate which is usurious in fact and in law.⁵⁷ Other courts have determined that it is unnecessary to show that the lender consciously intended to exact usury but that this intent will be implied if the loan contract does indeed demand a usurious rate of return.⁵⁸

Since usury is set up to disallow high interest loans, some argue that these laws should be strictly enforced as a means of controlling the payday lending industry. The federal Military Lending Act is an example of strict usury requirements used to prevent military personnel from getting trapped in the payday loan cycle of debt. As required by the Act, certain lending institutions, including payday lending companies, may not make loans with

⁵³ 44B AM. JUR. 2D *Interest and Usury* § 81 (2007).

⁵⁴ Thomas, *supra* note 45, at 2418.

⁵⁵ See Christopher L. Peterson, *Preemption, Agency Cost Theory, and Predatory Lending by Banking Agents: Are Federal Regulators Biting Off More than they Can Chew?*, 56 AM. U. L. REV. 515, 550 (2007). In California, parties may contract for interest on a loan primarily for personal, family, or household purposes at a rate not exceeding 10% per year. CA CONST. art. XV, § 1. In Ohio, "parties to a bond, bill, promissory note, or other instrument of writing for the forbearance or payment of money at any future time, may stipulate therein for the payment of interest upon the amount thereof at any rate not exceeding eight per cent per annum payable annually . . ." OHIO REV. CODE ANN. § 1343.01 (West 1988).

⁵⁶ 9 RICHARD A. LORD, WILLISTON ON CONTRACTS § 20.4 (4th ed. 1992).

⁵⁷ *Id.*

⁵⁸ *Id.*

higher than a 36% interest rate to military personnel or their families.⁵⁹ This law takes the position that interest rate caps are an efficient way to control predatory lending, at least for a certain vulnerable portion of the population.⁶⁰

While strict enforcement of usury laws seems to work on its face, it does not get to the real scope of the payday lending problem for three reasons. First, in *Beneficial National Bank v. Anderson*, the Supreme Court ruled that state usury laws do not bind national banks and “there is, in short, no such thing as a state-law claim of usury against a national bank.”⁶¹ This means that it is impossible to bring a charge of usury against a payday lending business that charter rents⁶² from a national bank (as long as the bank technically makes and retains the risk on the loan).⁶³ Since the case law is established, one of the only ways usury laws could be efficient in curbing payday lending is for Congress to pass a federal usury law. Second, payday lending companies would go out of business because they would be unable to afford making high risk loans for a profit.⁶⁴ While this may be the ultimate goal of some consumer groups, payday lending does provide a valuable service to members of the community who do not want to go through the long process of a bank loan or are not credit-worthy enough for traditional lending options.⁶⁵ Third, payday loans are fundamentally different from other types of loans because they are short-term, so an interest rate of 391% could only amount to \$15 on a \$100 loan.⁶⁶ Considering that the average payday loan customer earns only \$25,000 a year or less, \$15 extra can be a

⁵⁹ Press Release, Center for Responsible Lending, *Military Lending Act to Take Effect October 1* (Sept. 27, 2007), available at http://www.consumerfed.org/pdfs/FINAL_MLA_take_effect_PR_9-27-07.pdf.

⁶⁰ *Id.* at 2. (“The interest rate cap is a good model for states. It’s the only thing that has proven to control predatory payday lending,” said Kathleen Keest, senior policy counsel for the Center for Responsible Lending.”).

⁶¹ *Beneficial Nat’l Bank v. Anderson*, 539 U.S. 1, 11 (2003).

⁶² *See infra* Part III.B.

⁶³ Steven M. Graves & Christopher L. Peterson, *Predatory Lending and the Military: The Law and Geography of “Payday” Loans in Military Towns*, 66 OHIO ST. L.J. 653, 708 (2005).

⁶⁴ Thomas, *supra* note 45, at 2424.

⁶⁵ *Id.* at 2424–25.

⁶⁶ *Id.* at 2423.

substantial amount.⁶⁷ The real problem, however, lies with the ability of payday loan borrowers to flip their loans.⁶⁸

B. Strict Usury Laws Have Failed to Regulate the Payday Lending Industry

State attempts to control payday lending businesses through strict usury laws have been unsuccessful. For example, Virginia attempted to eliminate payday lending by restricting annual percentage rates to 36% for small loans.⁶⁹ This did not work because of a loophole in the National Bank Act (NBA) where nationally chartered banks can charge the interest rate allowed in the state the bank is located and not the state the bank makes the loan in.⁷⁰ Payday loan companies take advantage of this loophole by contracting with nationally chartered banks so that the bank technically extends credit to the payday loan borrower.⁷¹ This process is known as “charter renting.”⁷²

In 2006, the state of Georgia attempted to close the charter renting loophole by passing legislation that forbids “in-state payday loan companies from issuing loans for and acting as an agent for out-of-state banks when the payday loan companies retain more than half of the proceeds from the loan.”⁷³ In response, payday loan companies and their out-of-state bank sponsors filed suit against the attorney general claiming the legislation was preempted by the Federal Deposit Insurance Act, the dormant Commerce Clause, and the Federal Arbitration Act.⁷⁴ The Eleventh Circuit ruled that the legislation did not violate any federal law due to the exception for out-of-state banks.⁷⁵ It is this exception that allows out-of-state banks to make

⁶⁷ See *id.* at 2406.

⁶⁸ *Id.* at 2410 (noting that the U.S. Comptroller of the Currency stated that “[o]ne of the principal features of payday loans that have led to abuses is frequent renewal, resulting in additional fees to the consumer.”); see also *supra* Part II.B.

⁶⁹ Thomas, *supra* note 45, at 2419.

⁷⁰ *Id.* at 2418–19.

⁷¹ *Id.* at 2419.

⁷² *Id.* at 2418.

⁷³ *Id.* at 2421. It also caps small consumer loans at Georgia’s small loan usury rate of 60% per year, adds stiff criminal and civil penalties for violators, and bars non-bank lenders from partnering with banks to avoid Georgia’s usury laws. Ellen Harnick, *Georgia’s Payday Loan Law: A Model for Preventing Predatory Payday Lending*, Center For Responsible Lending Policy Analysis, 2 (June 2006).

⁷⁴ Thomas, *supra* note 45, at 2421; Harnick, *supra* note 73, at 2.

⁷⁵ *Bankwest, Inc. v. Baker*, 411 F.3d 1289, 1302 (11th Cir. 2005) (remanded for mootness). The Eleventh Circuit stated that:

payday loans on their own behalf that may make legislation fruitless in the ultimate goal to secure fair payday loan contract terms for consumers.⁷⁶

While it remains to be seen exactly how effective Georgia's law is in curbing triple digit interest rates for payday loans, it could eliminate a legitimate credit option for many consumers who rely on payday lending.⁷⁷ Because the payday lending institutions do serve a valid purpose, and attempts to get rid of the industry all together have proven futile, payday loan customers must be given more protection. Thus, the current business practices of payday lending companies, including mandatory arbitration clauses, must be carefully scrutinized for fairness.

IV. MANDATORY ARBITRATION CLAUSES ARE UNCONSCIONABLE

Many payday lending companies require borrowers to sign contracts that require any dispute between the company and the consumer to be resolved in mandatory arbitration.⁷⁸ While voluntary arbitration is held as a venerable method of dispute resolution in the United States, mandatory arbitration is controversial because it is often nonconsensual.⁷⁹ Mandatory arbitration clauses in payday lending contracts should be required to meet the legal requirements of conscionability so that they are not deemed unconscionable by the courts.⁸⁰

For the following reasons, the Act does not stand as an obstacle to achieving this objective or substantially impair the right created by the federal law, and, therefore, there is no conflict preemption. First, and most important, the Act provides a complete exemption to out-of-state banks for liability under the Act . . . Second, the Act does not prohibit out-of-state banks from using independent agents, including payday stores, or other partnerships to make payday loans at their home-state interest rates in Georgia . . . In addition, the Act leaves open other alternatives for out-of-state banks to export their home-state interest rates to Georgia borrowers.

Id.

⁷⁶ See Thomas, *supra* note 45, at 2421. On the other hand, The Center for Responsible Lending argues that the Georgia law "is a useful example of how state laws can proscribe both predatory lending and lender attempts at subterfuge, including those involving out-of-state or national banks." Harnick, *supra* note 73, at 4.

⁷⁷ Thomas, *supra* note 45, at 2421.

⁷⁸ See *infra* Part IV.A.

⁷⁹ See *infra* Part IV.A.

⁸⁰ See *infra* Part IV.C.

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A. Mandatory Arbitration Clauses in Payday Lending Contracts: A Trap for the Unwary Financially Strapped Consumer

Currently, many payday loan companies require their customers to agree to mandatory arbitration in their loan contract.⁸¹ Arbitration is a method of dispute resolution involving one or more neutral third parties who are usually agreed to by the disputing parties and whose decision is binding.⁸² Mandatory arbitration clauses require parties to resolve their legal issue in arbitration instead of in court.⁸³

Voluntary arbitration is a favored form of dispute resolution by U.S. courts and Congress.⁸⁴ According to the most recent U.S. Supreme Court decision, the passage of the Federal Arbitration Act (FAA)⁸⁵ in 1925 “declared a national policy favoring arbitration” and took away the power of the states to require a courtroom trial when the contracting parties agreed to resolve the dispute through arbitration methods.⁸⁶ This set the stage for Supreme Court opinions tolerating mandatory arbitration between individual and commercial entities.⁸⁷

Mandatory arbitration has been criticized as unfair to consumers because the agreements are nonconsensual, companies slant the odds in their favor,

⁸¹ Kelly J. Noyes, Comment, *Get Cash Until Payday! The Payday-Loan Problem in Wisconsin*, 2006 WIS. L. REV. 1627, 1672 (2006).

⁸² BLACK’S LAW DICTIONARY 112 (8th ed. 2004).

⁸³ *Id.*

⁸⁴ Sternlight, *supra* note 1, at 1636.

⁸⁵ Section two of the Federal Arbitration Act states:

A written provision in any maritime transaction or a contract evidencing a transaction involving commerce to settle by arbitration a controversy thereafter arising out of such contract or transaction, or the refusal to perform the whole or any part thereof, or an agreement in writing to submit to arbitration an existing controversy arising out of such a contract, transaction, or refusal, 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 (2000).

⁸⁶ *Southland Corp. v. Keating*, 465 U.S. 1, 10 (1984).

⁸⁷ See Sternlight, *supra* note 1, at 1636. In the Supreme Court decisions *Moses H. Cone Memorial Hospital v. Mercury Construction Corp.*, 460 U.S. 1 (1983) and *Gilmer v. Interstate/Johnson Lane Corp.*, 500 U.S. 20 (1991), the Court stated that commercial arbitration is favored. Sternlight argues that these decisions surprised corporations because it allowed them to use arbitration in situations previously not thought possible for public policy reasons. Sternlight, *supra* note 1, at 1636. As a result, many corporations instituted contracts requiring customers to agree to resolve all future disputes through arbitration. See *id.*

and consumers may be denied substantive relief.⁸⁸ Mandatory arbitration agreements are argued to be nonconsensual because most consumers do not read or understand the contract they are signing and therefore do not realize they are signing away their right to a courtroom trial.⁸⁹ This is especially true for payday loan customers since many are desperate for cash and not highly educated.⁹⁰

Many critics of mandatory arbitration also assert that companies try to slant the arbitration in a way that favors them and not the consumer by using such tactics as high costs, company selection of arbitrator, and remedy limitations.⁹¹ Additionally, companies that write their own mandatory arbitration clauses may bar substantive relief that the consumer would be entitled to under a court process, such as attorney fees, compensatory damages, punitive damages, or even the ability to appeal.⁹² The negative consequences of arbitration are so numerous that lawyers in South Carolina have been advised to list the ways arbitration differs from litigation in retainer agreements if they are contemplating mandating arbitration for malpractice suits.⁹³

Mandatory arbitration has also been criticized because it allows issues of public interest to be tried in secrecy.⁹⁴ Arbitration proceedings and

⁸⁸ *Id.* at 1649–53.

⁸⁹ *Id.* at 1649.

⁹⁰ Creola Johnson, *Payday Loans: Shrewd Business or Predatory Lending?*, 87 MINN. L. REV. 1, 101 (2002).

⁹¹ Sternlight, *supra* note 1, at 1649–50.

⁹² *Id.* at 1652–53. Sternlight notes that many courts have stricken down mandatory arbitration clauses trying to deny consumers substantive relief. However, attacks on these clauses are costly to litigate and lawyers who work on a contingent fee may be reluctant to take these cases. *Id.* at 1653.

⁹³ John Freeman, *Ethics Watch: The New Rules and You*, 17 S.C. LAW. 9, 9 (Mar. 2006). Freeman notes that:

Among the arguably negative consequences of arbitration are that the client will lose his or her right to: a jury trial, a presiding judge bound by the Code of Judicial Conduct, full discovery proceedings, certain evidentiary rules or a right to findings based on the evidence with explicit legal reasoning. Additionally, the client should be told that his or her ability to appeal adverse decisions will be curtailed, and costs of the proceeding may be higher than in a court case.

Id.

⁹⁴ Stephanie Brenowitz, Note, *Deadly Secrecy: The Erosion of Public Information Under Private Justice*, 19 OHIO ST. J. ON DISP. RESOL. 679, 680 (2004) (arguing that the switch from public litigation to private justice alternative dispute methods such as arbitration keeps important issues of public interest a secret).

settlements are confidential.⁹⁵ While confidentiality may be legitimate in circumstances of trade secrets, issues of consumer interest should be public so that industry-wide patterns of abuse can be exposed and businesses are forced to openly admit wrong-doing.⁹⁶ Additionally, arbitrators themselves lack public accountability in procedure and in written works, whereas the judiciary's work is open and published.⁹⁷ This means that the public never gets a chance to discuss perceived injustices and demand legislative action—a vital part of the democratic process.⁹⁸ Since the payday lending industry charges triple digit interest rates and profits on chronic borrowers, its use of mandatory arbitration clauses is a good candidate for public dispute and industry-wide admittance of wrong-doing.

B. Unconscionability: A Murky Legal Subject

Arbitration clauses can be struck down by courts through the common law standard of unconscionability.⁹⁹ Common law contract defenses to mandatory arbitration clauses are allowed because the FAA specifically states that arbitration clauses may be invalidated based “upon such grounds as exist at law or in equity for the revocation of any contract.”¹⁰⁰ Generally, unconscionability “is determined by reference to the relative benefit of the bargain to the parties at the time of its making, the nature of the methods employed in negotiating it, and the relative bargaining power of the parties.”¹⁰¹

The Uniform Commercial Code (UCC) does not define unconscionability in the text of the statute,¹⁰² but it does clarify the concept

⁹⁵ *Id.* at 689, 694.

⁹⁶ *Id.* at 690 (“Hiding the outcome of meritorious dispute can shield the losing party from any implication that it has done something wrong, which can have greater consequences down the line.”).

⁹⁷ *Id.* at 701 (“In the litigation context, judges are known entities to the public. Their work is published, their professional histories can be traced, and their actions are ultimately subject to the inspection of the press and the public.”).

⁹⁸ *See id.* at 684–85. (“The purpose of an open judicial system is to safeguard justice by opening its processes to the light of day, to make sure that parties are treated fairly. Yet another equally important function is to reveal the content of litigation to the press and the public.”).

⁹⁹ Sternlight, *supra* note 1, at 1643.

¹⁰⁰ 9 U.S.C. § 2 (2000).

¹⁰¹ *U.S. v. Bedford Assoc.*, 657 F.2d 1300, 1313 (2d Cir. 1981).

¹⁰² UCC § 2-302 (1) and (2) state:

in its Official Comment. Under the Official Comment, the test of unconscionability is whether the contract clause is so one-sided it is unconscionable based on all the surrounding circumstances at the time the contract was made.¹⁰³ The main standard of unconscionability is “the prevention of oppression and unfair surprise, and not of disturbance of allocation of risks because of superior bargaining power.”¹⁰⁴ Because of this standard, unconscionability is often found in contracts between sophisticated businesses and unsophisticated consumers.¹⁰⁵ The approach of the UCC and most states regarding the determination of whether a contract is unconscionable, however, is *ad hoc*, and the only standardized rules regarding its determination are the ideas of procedural and substantive unconscionability.¹⁰⁶

In order for a contract to be unconscionable in most states, it must be both procedurally and substantively unconscionable.¹⁰⁷ Procedural

(1) If the court as a matter of law finds the contract or any clause of the contract to have been unconscionable at the time it was made the court may refuse to enforce the contract, or it may enforce the remainder of the contract without the unconscionable clause, or it may so limit the application of any unconscionable clause as to avoid any unconscionable result. (2) When it is claimed or appears to the court that the contract or any clause thereof may be unconscionable the parties shall be afforded a reasonable opportunity to present evidence as to its commercial setting, purpose and effect to aid the court in making the determination.

Id.

¹⁰³ UCC § 2-302, Comment 1 states:

The basic test is whether, in the light of the general commercial background and the commercial needs of the particular trade or case, the clauses involved are so one-sided as to be unconscionable under the circumstances existing at the time of the making of the contract . . . The principle is one of the prevention of oppression and unfair surprise, and not of disturbance of allocation of risks because of superior bargaining power.

Id.

¹⁰⁴ *Id.*

¹⁰⁵ See 8 RICHARD A. LORD, WILLISTON ON CONTRACTS § 18:10 (4th ed. 1992). This assertion comes from numerous federal cases listed in the Williston text. The Supreme Court has not dealt with the theory of unconscionability or set standards regarding its determination. Additionally, each state has different demands for procedural and substantive unconscionability. Due to these factors, Williston on Contracts is the most developed resource on the subject of unconscionability.

¹⁰⁶ *Id.* at § 18:11.

¹⁰⁷ *Id.* In the Sixth Circuit, the test of unconscionability is two pronged and inquires: “(1) What is the relative bargaining power of the parties, their relative economic strength,

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unconscionability is usually classified as surprise or inability to negotiate the terms of the contract with comprehension.¹⁰⁸ Substantive unconscionability is usually described as unfair or unreasonable contract terms.¹⁰⁹ Some disparity in bargaining power is allowed by courts, but “gross inequality of bargaining power, together with terms unreasonably favorable to the stronger party, may confirm . . . that the transaction involved elements of deception or compulsion, or may show that the weaker party had no meaningful choice, no real alternative, or did not in fact assent . . . to the unfair terms.”¹¹⁰ Many courts first decide if both forms of unconscionability are present and then balance the two to determine the result of the case.¹¹¹

Since the test of unconscionability is so amorphous and fact-specific, judges are often loathe to invalidate contracts supposedly containing the intent of both parties,¹¹² and lawyers therefore find it difficult to weigh their client’s chance of winning the case.¹¹³ This uncertainty will impede low

the alternative sources of supply, in a word, what are their options?; (2) Is the challenged term substantively reasonable?” *Anderson Inc. v. Horton Farms Inc.*, 166 F.3d 308, 322 (6th Cir. 1998). In the Ninth Circuit, procedural unconscionability:

is manifested by (1) “oppression,” which refers to an inequality of bargaining power resulting in no meaningful choice for the weaker party, or (2) ‘surprise,’ which occurs when the supposedly agreed-upon terms are hidden in a document. Substantive unconscionability is an overly harsh allocation of risks or costs which is not justified by the circumstances under which the contract was made. Both procedural and substantive unconscionability must be present before a contract or clause will be held unenforceable.

Navellier v. Sletten, 262 F.3d 923, (9th Cir. 2001).

¹⁰⁸ WILLISTON ON CONTRACTS, *supra* note 105, at § 18:10.

¹⁰⁹ “Substantive unconscionability refers to contractual terms that are unreasonably or grossly favorable to one side and to which the disfavored party does not assent.” *Harris v. Green Tree Financial Corp.*, 183 F.3d 173, 181 (3d Cir. 1999). Since the UCC does not explicitly mention procedural unconscionability, some states have decided that substantive unconscionability is the only standard of unconscionability that cases should be decided upon. *See* WILLISTON ON CONTRACTS, *supra* note 105, at § 18:10.

¹¹⁰ *Wisconsin Auto Title Loans, Inc. v. Jones*, 714 N.W.2d 155, 169 n.2 (Wis. 2006). In this case, the Wisconsin Supreme Court ruled that a one-sided arbitration provision in an auto loan contract, which required indigent borrowers to arbitrate all claims while the lender remained free to enforce its rights in court, was unconscionable.

¹¹¹ WILLISTON ON CONTRACTS, *supra* note 105, at § 18:10.

¹¹² *See* 17A AM. JUR. 2D *Contracts* § 277 (2000). (“[I]n the absence of any mistake, fraud, or oppression, the courts, as such, are not interested in the wisdom of contracts and agreements voluntarily entered into between competent parties.”).

¹¹³ *See Sternlight*, *supra* note 1, at 1653 (arguing that “when attorneys make a determination as to whether to represent a particular client, particularly on a contingent fee basis, they take into account the extent of the client’s likely recovery, if successful.”).

income clients, the vast majority of payday loan borrowers, from retaining quality legal representation on a contingency fee.¹¹⁴

C. Mandatory Arbitration Clauses in Payday Lending Contracts are Unconscionable

Mandatory arbitration clauses in payday lending contracts are procedurally and substantively unconscionable. They are procedurally unconscionable based on surprise and real incapability of payday lending consumers to comprehend the terms of contract. They exhibit both lack of meaningful choice for one party and contractual terms that are unreasonably favorable to another party. Moreover, there have been charges of oral misrepresentation of the contract by payday loan workers to borrowers.¹¹⁵

The arbitration clauses are substantively unconscionable because they are contractually unreasonable in light of the surrounding circumstances and because of gross power disparities between the average payday lending customer and the payday lender. For instance, most payday borrowers do not have a legal sense of contracts and are desperate for money—they do not know that they are signing away the right to a trial, do not understand what arbitration means, and do not have the option of bargaining for a different contract.¹¹⁶ Further, most payday lending businesses are placed in

¹¹⁴ See *id.*

¹¹⁵ See Michael Bertics, Note, *Fixing Payday Lending: The Potential of Greater Bank Involvement*, 9 N.C. BANKING INST. 133, 139–49 (2005) (noting that surveys in Ohio show that many payday lending businesses will not allow consumers to take contracts home to read them, provide false information to customers about the terms of loan, and only disclose interest rates at the very end of the transaction, among other highly evasive lending techniques).

¹¹⁶ See *Wisconsin Auto Title Loans, Inc. v. Jones*, 714 N.W.2d at 178–79 (Wis. 2006) (Butler, J., concurring). Justice Butler argued against mandatory arbitration clauses in short-term auto loan contracts by stating:

[C]harging 300 percent interest for a short-term loan to those who can ill-afford it is ridiculous, unreasonable, and unconscionable Predatory lenders exploit borrowers through excessively high interest rates. Consumers who must borrow money this way are usually in desperate debt. These lenders target low-income consumers, individuals with stained credit scores, and those in society who cannot access traditional sources of money and credit. The high rates that predatory lenders charge make it difficult for borrowers to repay the loan, resulting in many consumers being driven onto a perpetual debt treadmill. Essentially, the predatory lender sets the borrower up to fail.

Id.

impoverished areas, have a clientele that are not highly educated, and charge rates higher than loan sharks.¹¹⁷ Based on the UCC's definition of unconscionability, mandatory arbitration clauses in payday lending contracts are unconscionable because the clauses are one-sided in favor of the payday lending companies under the circumstances existing at the time of making the contract.

Opponents of the unconscionability defense argue the doctrine is too vague to be helpful and should be disposed of by courts.¹¹⁸ However, because the historical and philosophical function of the unconscionability doctrine is to protect societal values such as fairness,¹¹⁹ it is ideal for challenging unfair mandatory arbitration clauses in payday loan contracts. Since unconscionability has been codified in the UCC § 2-302, which was accepted by every state except Louisiana, there is little chance the formalists will convince states and courts to discard the unconscionability doctrine in the near future.¹²⁰ Therefore, resting contemporary social problems such as payday lending on the legal argument of unconscionability is legitimate. This legitimate claim, however, is muddled by the separability doctrine and split federal jurisdictions.

D. The Doctrine of Separability and Split Courts: Impeding Future Unconscionability Claims for Payday Lending Consumers

1. The Doctrine of Separability

Federal jurisdictions have split over whether it is the job of the court or the arbitrator to decide whether mandatory arbitration clauses are unconscionable. In 1961, the Supreme Court introduced the "separability

¹¹⁷ See Thomas, *supra* note 45, at 2406–07; see also BLACK'S LAW DICTIONARY 1561 (8th ed. 2004) (defining unconscionable as "(Of an act or transaction) showing no regard for conscience; affronting the sense of justice, decency, or reasonableness.").

¹¹⁸ See Amy J. Schmitz, *Embracing Unconscionability's Safety Net Function*, 58 ALA. L. REV. 73, 73 (2006) (noting the "popular formalist critiques of unconscionability that urge for the doctrine's demise or constraint based on claims that its flexibility and lack of clear definition threaten efficiency in contract law.").

¹¹⁹ *Id.* ("[U]nconscionability is necessarily flexible and contextual in order to serve its historical and philosophical function of protecting core human values. Unconscionability is not frivolous gloss on classical contract law. Instead, it provides a flexible safety net for catching contractual unfairness that slips by formulaic contract defenses.").

¹²⁰ *Id.* at 89–90. ("Unconscionability should therefore survive modern formalism's fight against flexible contract standards, and embrace its flexibility in order to serve as a safety net for protecting societal fairness norms.").

doctrine" for mandatory arbitration in *Prima Paint Corp. v. Flood & Conklin Mfg. Co.*, essentially stating that mandatory arbitration clauses can be separated out from the contract as a whole.¹²¹ *Prima Paint* stated that the FAA requires that claims of fraud in the inducement of an agreement to arbitrate be heard by the court, but fraud in the inducement of an entire contract must go to an arbitrator.¹²² Therefore, unless the arbitration clause itself is induced by a limited number of defenses, such as fraud or duress, the court must uphold the arbitration clause in the contract.¹²³ Accordingly, mandatory arbitration clauses cannot be challenged based on the unconscionability of the contract as a whole.¹²⁴

In *Buckeye Check Cashing, Inc. v. Cardegna*, the Supreme Court reaffirmed the separability doctrine of *Prima Paint* and extended the doctrine to state courts in a case of alleged usurious loans by a check cashing business.¹²⁵ *Buckeye Check Cashing* is an important decision for payday loan cases because it demonstrates the Court's unwillingness to change the terms of contracts. It also reveals that the Supreme Court may be prepared to uphold payday lending contracts that contain possibly unconscionable mandatory arbitration clauses unless the plaintiff charges that the arbitration clause itself is unconscionable based on the FAA.¹²⁶

¹²¹ *Prima Paint Corp. v. Flood & Conklin Mfg. Co.*, 388 U.S. 395, 403–04 (1961). In *Prima Paint*, Flood & Conklin brought an action to rescind a contract on the grounds that it had been fraudulently induced. *Prima Paint* argued that an arbitrator, and not the Court, should decide if the contract was valid due to its mandatory arbitration clause. The Supreme Court agreed with *Prima Paint* and concluded that because Flood & Conklin was challenging the whole contract and not just the arbitration clause, the claim of inducement was for the arbitrator to decide.

¹²² *Id.*

¹²³ Joseph L. Franco, Comment, *Casually Finding the Clear and Unmistakable: A Re-Evaluation of First Options in Light of Recent Lower Court Decisions*, 10 LEWIS & CLARK L. REV. 443, 446 n.13 (2006).

¹²⁴ See *id.* at 453. ("Applying the language of [FAA] section 4, the Court reasoned that a party seeking to avoid arbitration has not placed the agreement to arbitrate in issue if the party attacks the contract generally rather than the arbitration agreement in particular. As a result, if a party has entered into an agreement containing an arbitration clause and wishes to avoid arbitration, that party will not succeed merely by attacking the validity of the contract generally.").

¹²⁵ *Buckeye Check Cashing Inc v. Cardegna*, 546 U.S. 440, 445–49 (2006). In *Buckeye Check Cashing*, Cardegna took out numerous "loans" from Buckeye by getting cash in exchange for a personal check and a finance charge. Each time Cardegna made an exchange, he signed an agreement with a mandatory arbitration clause. Cardegna alleged Buckeye charged usurious interest rates and violated consumer protection laws. Buckeye demanded that the case go to mandatory arbitration and the Supreme Court agreed. *Id.*

¹²⁶ See Franco, *supra* note 123, at 453.

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In reality, the cost, time, and effort of litigating cases based solely on the unconscionability of a mandatory arbitration clause may make this option nearly impossible for many payday lending consumers.¹²⁷ This means that most unconscionable mandatory arbitration clauses will never be brought to court because neither attorneys nor their clients have the resources or the willingness to go through the lengthy and uncertain process of trying such cases.¹²⁸ Since alternative dispute resolution offers lower cost and higher flexibility methods than formal litigation, it is a more realistic option for low-income payday lending borrowers. Mandatory arbitration, however, is not the best answer.¹²⁹

2. Federal and State Jurisdictions are Split over Unconscionability of Mandatory Arbitration Clauses

Another hurdle for payday loan borrowers contesting their contracts is that federal and state courts are split over whether mandatory arbitration clauses are unconscionable. In *Jenkins v. First American Cash Advance of Georgia, LLC*, the Eleventh Circuit found that the unconscionability of mandatory arbitration clauses in payday lending contracts is for the arbitrator to decide.¹³⁰ On the other hand, in *Alabama Catalog Sales v. Harris*, the Alabama Supreme Court held that the trial court, rather than an arbitrator, is to decide whether contracts containing arbitration clauses are void and unenforceable.¹³¹

Alabama Catalog Sales is an important case to payday lending because it adheres to a narrow reading of *Prima Paint* instead of the broad reading that

¹²⁷ Sternlight, *supra* note 1, at 1655–56.

¹²⁸ *See id.* at 1656.

¹²⁹ *See supra* Part IV.B; *see also infra* Part VI.B.

¹³⁰ *Jenkins v. First Am. Cash Advance of Ga., LLC*, 400 F.3d 868, 876–77 (11th Cir. 2005). In *Jenkins*, the plaintiff signed mandatory arbitration contracts each time she took out a payday loan. Jenkins charged First American with usurious rates and First American moved to compel arbitration. The appellate court's decision to leave the issue of unconscionability to the arbitrator reversed the district court's holding that the mandatory arbitration clauses in payday lending contracts were unconscionable.

¹³¹ *Ala. Catalog Sales v. Harris*, 794 So. 2d 312, 317 (Ala. 2000). In this case, Harris charged Alabama Catalog Sales with violating the Alabama Small Loan Act by making illegal payday loans, charging usurious interest rates, and collecting on the loans without a license from the Bureau of Loans of the State of Alabama. Harris also argued that her contracts with Alabama Catalog Sales were void because of illegality so the arbitration agreements in the contracts were void. Alabama Catalog Sales argued that the arbitration agreements were valid and should be enforced. The court held that the trial court, and not an arbitrator, must decide if the contract is legal and enforceable.

many other jurisdictions follow. The court states that *Prima Paint* does not apply to this case because it centers on whether a contract really exists and not an attempt to completely rescind an acknowledged contract.¹³² “[A] party who contests the making of a contract containing an arbitration provision cannot be compelled to arbitrate the threshold issue of the *existence* of an agreement to arbitrate. Only a court can make that decision.”¹³³ The narrow reading of *Prima Paint* used in this case could be an escape from the separability doctrine’s suppression of unconscionability arguments for payday lending contracts.

V. CLASS ACTION SUITS SHOULD NOT BE DENIED TO PAYDAY LOAN CONSUMERS

Class action suits are one of the most viable ways for payday lending consumers to get the resources to have their cases tried.¹³⁴ Jurisdictions have split over whether class action waivers are unconscionable in contracts.¹³⁵ Many payday loan contracts contain a class action suit waiver just as they contain a mandatory arbitration clause.¹³⁶ In order to properly protect consumers, class action waivers should be declared unconscionable or simply unlawful.¹³⁷

A. *What Is A Class Action Suit and What Is A Class Action Waiver?*

A class action suit is a lawsuit where the court authorizes a single person or small group to represent the interests of a larger group.¹³⁸ There are generally four prerequisites to a class action suit according to Rule 23 of the Federal Rules of Civil Procedure.¹³⁹ Those prerequisites are:

- (1) the class is so numerous that joinder of all members is impracticable; (2) there are questions of law or fact common to the class; (3) the claims or defenses of the representative parties are typical of the claims or defenses of

¹³² *Id.* at 314 n.2.

¹³³ *Id.* (quoting *Shearson Lehman Bros., Inc. v. Crisp*, 646 So. 2d 613, 616–17 (Ala. 1994) (emphasis original)).

¹³⁴ See *infra* Part V.A.

¹³⁵ See *infra* Part V.B.

¹³⁶ See *infra* Part V.B.

¹³⁷ See *infra* Part V.B.

¹³⁸ BLACK’S LAW DICTIONARY 267 (8th ed. 2004).

¹³⁹ *Id.*

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the class; and (4) the representative parties will fairly and adequately protect the interests of the class.¹⁴⁰

If all of these prerequisites are met, the suit must meet one requirement of 23(b) in order to be maintained.¹⁴¹

Class action suits are advantageous because they permit plaintiffs access to the courts by allowing plaintiffs the opportunity to pool their resources and combine their claims in instances where no one plaintiff has endured substantial enough injury to support the underlying claim.¹⁴² Class action suits are also appropriate for payday loan consumers because they are a way to enforce the rights of the poor.¹⁴³ Most class action suits are taken on a contingency fee basis where the attorney does not get paid unless the class collects a recovery.¹⁴⁴ Since attorneys are willing to take them on a

¹⁴⁰ FED. R. CIV. P. 23(a).

¹⁴¹ *Id.* at 23(b). Rule 23(b) provides that:

A class action may be maintained if Rule 23(a) is satisfied and if: (1) prosecuting separate actions by or against individual class members would create a risk of: (A) inconsistent or varying adjudications with respect to individual class members that would establish incompatible standards of conduct for the party opposing the class; or (B) adjudications with respect to individual class members that, as a practical matter, would be dispositive of the interests of the other members not parties to the individual adjudications or would substantially impair or impede their ability to protect their interests; (2) the party opposing the class has acted or refused to act on grounds that apply generally to the class, so that final injunctive relief or corresponding declaratory relief is appropriate respecting the class as a whole; or (3) the court finds that the questions of law or fact common to class members predominate over any questions affecting only individual members, and that a class action is superior to other available methods for fairly and efficiently adjudicating the controversy. The matters pertinent to these findings include: (A) the class members' interests in individually controlling the prosecution or defense of separate actions; (B) the extent and nature of any litigation concerning the controversy already begun by or against class members; (C) the desirability or undesirability of concentrating the litigation of the claims in the particular forum; and (D) the likely difficulties in managing a class action.

Id.

¹⁴² Katie Melnick, *In Defense of the Class Action Lawsuit: An Examination of the Implicit Advantages and a Response to Common Criticisms*, 22 ST. JOHN'S J. LEGAL COMMENT. 755, 788 (2008).

¹⁴³ *Id.* at 789 (stating "'When the plaintiff is poor, marginalized, legally incompetent, ignorant of legal rights, or unable to assert rights for fear of sanctions or otherwise, and these disabilities are shared by others similarly situated, the class action may be the only effective means to obtain judicial relief.'") (quoting Lynn Pierce, *Trend and Development: Raising the Roof on Community Housing for People with Disabilities: Class Actions in Canada*, 6 APPEAL 22 (2000)).

¹⁴⁴ Melnick, *supra* note 142, at 789–90.

contingent basis, class action suits are a realistic way for indigent parties to obtain quality legal representation.¹⁴⁵

Many large businesses, including the payday loan industry, oppose class action suits because they are a way of regulating corporations that make it cost-prohibitive to litigate small claims.¹⁴⁶ Without class action suits, many businesses are able to commit wrongdoings without answering to consumers.¹⁴⁷ To protect themselves against the damage of class action suits, many industries have placed class action waivers in contracts of adhesion.¹⁴⁸ These class action waivers require consumers to relinquish their rights to class action remedies upon agreement to the contract.¹⁴⁹

B. Although Jurisdictions Are Split, Contractual Class Action Waivers Are Unconscionable

1. Jurisdictions Split over Whether Class Action Waivers in Contracts are Unconscionable

Jurisdictions have split over whether class action waivers in consumer contracts are unconscionable.¹⁵⁰ The Second, Third, Fourth, Fifth, Sixth, Seventh, Eighth, Ninth,¹⁵¹ and Eleventh Circuits have all held that class

¹⁴⁵ See *id.*

¹⁴⁶ See *id.* at 790.

¹⁴⁷ *Id.* at 791 (“[W]ithout the class action device, many businesses would arguably be able to escape answering for their wrong-doings until they injured someone so substantially that it became cost effective for the injured victim to pursue the claim individually.”).

¹⁴⁸ See Nivine K. Zakhari, *Is The Class Action Fairness Act of 2005 A Misnomer? The Impact on Class Action Waivers in Consumer ADR Clauses*, 5 J. AM. ARB. 97, 107 (2006).

¹⁴⁹ *Id.* at 97.

¹⁵⁰ See Alan S. Kaplinsky, *A Scorecard on Where Federal and State Appellate Courts and Statutes Stand on Enforcing Class Action Waivers in Pre-Dispute Consumer Arbitration Agreements*, 1591 PLI/CORP 9, 13–17 (2007).

¹⁵¹ The Ninth Circuit has contradictory opinions, and it is not clear that the earlier decisions have been overruled. For example, in *Horenstein v. Mortgage Market, Inc.*, 9 Fed. Appx. 618 (9th Cir. 2001), the court held that the appellant’s contention that the arbitration clause in the employment agreements may not be enforced because it eliminates their statutory right to a collective action suit under the Fair Labor Standards Act is sufficient to render an arbitration clause unenforceable. However, in *Circuit City Stores, Inc. v. Mantor*, 335 F.3d 1101 (9th Cir. 2003), the Ninth Circuit held that class action waivers are unconscionable.

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action waivers in contracts are not unconscionable.¹⁵² For example, in *Snowden v. Checkpoint Check Cashing*, the Fourth Circuit ruled that an arbitration clause was not unconscionable merely because it contained a provision excluding arbitration of disputes on class action basis.¹⁵³ Snowden, who partook in twelve deferred-deposit transactions over the course of nine months, brought an alleged class action against Checkpoint, a check cashing lender, asserting violations of the Truth in Lending Act (TILA), the Racketeer Influenced and Corrupt Organizations Act (RICO), and the Maryland Consumer Protection Act.¹⁵⁴ The court rejected Snowden's claim that she could not retain legal services without class action standing due to the small amount of damages in her case because both TILA and RICO provide for the recovery of attorney's fees by a prevailing plaintiff.¹⁵⁵ Additionally, the court did not believe that class action waivers were against a public policy of consumer protection.¹⁵⁶

On the other hand, courts in the First and the Ninth Circuits have invalidated class action waivers¹⁵⁷ and numerous state courts have held that the denial of class action rights in contracts is unconscionable.¹⁵⁸ In *Ting v. AT&T*, AT&T used new customer service agreements to limit its customers' legal rights and remedies to counteract its mandatory detariffing obligations.¹⁵⁹ Under the detariffing, telephone companies had to establish

¹⁵² Kaplinsky, *supra* note 150, at 13–16.

¹⁵³ *Snowden v. CheckPoint Check Cashing*, 290 F.3d 631, 638 (4th Cir. 2002).

¹⁵⁴ *Id.* at 634–35.

¹⁵⁵ *Id.* at 638.

¹⁵⁶ *Id.* at 639 (“Snowden has presented no authority or evidence establishing that the arbitral forum contemplated by the FAA and provided in the Arbitration Agreement is inconsistent with public policy relating to consumer protection. Indeed, we have recognized the arbitral forum specified by the Arbitration Agreement as one provided by a reputable arbitration organization . . . We also note that the Arbitration Agreement places no limitations upon the substantive remedies available to Snowden in arbitration. In sum, we can discern no violation of public policy relating to consumer protection by requiring Snowden to resolve her claims against Elite in the arbitral forum.”).

¹⁵⁷ Kaplinsky, *supra* note 150, at 17.

¹⁵⁸ *Cooper v. QC Financial Services, Inc.*, 503 F. Supp. 2d 1266 (D. Ariz. 2007). The court in *Cooper v. QC Financial Services, Inc.* held that under Arizona law, the waiver of the right to a class action and class arbitration was substantively unconscionable in an agreement for payday loans, even though the arbitration provision containing the waiver was binding on the lender and it was responsible for arbitration fees. In *Muhammad v. County Bank of Rehoboth Beach, Delaware*, 189 N.J. 1 (2006), the New Jersey Supreme Court held that an arbitration provision which forbids class-wide arbitration was unconscionable due to the public interest in class actions as a means to seeking redress for harms.

¹⁵⁹ *Ting v. AT&T*, 319 F.3d 1126, 1133 (9th Cir. 2003).

individual contracts with customers defining rates and terms instead of filing their rates with the Federal Communications Committee, which gave consumers contract rights.¹⁶⁰ One method AT&T used to deny its customers legal remedy was to mandate binding arbitration and ban all class action suits.¹⁶¹ The Ninth Circuit followed a lower court in holding that the class action waiver was manifestly one-sided and therefore substantively unconscionable.¹⁶²

2. Contract Class Action Waivers Are Unconscionable

Denying class actions suits should be prohibited as a matter of fairness and justice because they prevent the law from being properly enforced.¹⁶³ Class action waivers are also substantively unconscionable because they are so one-sided as to “shock the conscience”¹⁶⁴ and procedurally unconscionable because of unfair surprise and oppression to the consumer. If banning class action suits in contracts of adhesion is unconscionable, there may be a reasonable parallel argument that denying a single person their right to litigate is unconscionable if they choose to forego the class action route.¹⁶⁵ One problem with this argument is that it could be contended that the unconscionability of barring class action suits has less to do with the prohibition itself and more to do with the fact that class action suits are the

¹⁶⁰ *Id.* at 1132.

¹⁶¹ *Id.* at 1133 n.3 (“Section 7, captioned ‘Dispute Resolution,’ sets forth procedures for resolving customer disputes. In approximately eight-point font (replicated below), section 7(a) provides in part: This section provides for resolution of disputes through final and binding arbitration before a neutral arbitrator instead of in a court by a judge or jury or through a class action. You continue to have certain rights to obtain relief from a federal or state regulatory agency No dispute may be joined with another lawsuit, or in an arbitration with a dispute of any other person, or resolved on a class wide basis. The arbitrator may not award damages that are not expressly authorized by this agreement and may not award punitive damages or attorneys’ fees unless such damages are expressly authorized by a statute. You and AT&T both waive any claims for an award of damages that are excluded under this agreement.”).

¹⁶² *Id.* at 1150.

¹⁶³ Jean R. Sternlight & Elizabeth J. Jensen, *Using Arbitration to Eliminate Consumer Class Actions: Efficient Business Practice or Unconscionable Abuse?*, 67 LAW & CONTEMP. PROBS. 75, 103 (2004).

¹⁶⁴ *M.A. Mortenson Co., Inc. v. Timberline Software Corp.*, 998 P.2d 305, 315 (Wash. 2000) (“Timberline’s consequential damages clause, when examined at the time the contract was formed, does not shock the conscience . . . it is not substantively unconscionable.”).

¹⁶⁵ See generally Sternlight & Jensen, *supra* note 163, at 79.

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most likely way payday consumers can win their case and receive remedies.¹⁶⁶

While it might be currently unlikely that individual claims against mandatory arbitration clauses will be brought, court decisions against mandatory arbitration clauses could open the door for individual litigants. Attorneys would have a better idea of the standards needed to prove individual unconscionability and the likelihood of their client's success. Additionally, non-profit legal aid and pro bono attorneys are interested in taking payday loan cases.¹⁶⁷ The concern of these attorneys over payday loan industry abuse means that there is a greater likelihood the cases will be brought to court and that the low income status of payday loan customers will not make an argument for the unconscionability of mandatory arbitration clauses in individual contracts moot.

VI. PUBLIC POLICY SUGGESTIONS FOR CHANGE AND A NEW WAY TO RESOLVE PAYDAY LENDING DISPUTES

A. Public Policy Mandates Federal Payday Loan Industry Regulation

The general response of the federal government has been to mandate that lending businesses provide consumers with more information about the nature of the loan in order to make knowledgeable credit decisions.¹⁶⁸ This sort of free-market response assumes that consumers will use the information to act rationally and that "bad actors" are pushed out of the economy.¹⁶⁹ While a hands-off approach is good in theory, the free-market method does not take into account the dire straights most payday lending consumers find themselves in when they walk through the doors.¹⁷⁰ Many payday lending customers are optimistic about their ability to pay back the loan in two weeks

¹⁶⁶ *Id.* at 85–88.

¹⁶⁷ See Paul Gores, *Legislators to Take Another Crack at a Payday-Loan Law; They Want Bill That Would Set Limits and Please Governor*, MILWAUKEE J. SENTINEL (Wisconsin), Aug. 19, 2005, at D1, available at LEXIS, News Library, <ALLNWS> File (showing that legal aid attorneys have taken an active role in studying and litigating payday loan cases).

¹⁶⁸ Laurie A. Burlingame, *A Pro-Consumer Approach to Predatory Lending: Enhanced Protection Through Federal Legislation and New Approaches to Education*, 60 CONSUMER FIN. L.Q. REP. 460, 466 (2006).

¹⁶⁹ *Id.*

¹⁷⁰ Charles A. Bruch, Note, *Taking the Pay out of Payday Loans: Putting an End to the Usurious and Unconscionable Interest Rates Charged by Payday Lenders*, 69 U. CIN. L. REV. 1257, 1271 (2001) (noting a payday lender as describing his customers to be "desperate persons in dire need.").

and are equally optimistic about never needing the right to sue the payday lending company.¹⁷¹ Anti-protectionist public policy theories are admirable in their insistence on treating consumers as competent adults who are capable of making their own decisions.¹⁷² In the case of mandatory arbitration clauses in payday loan contracts, however, public policy dictates a consumer protectionist response.¹⁷³

The proper public policy is to give consumers a real choice as to whether to choose arbitration over courtroom litigation. Payday loan company employees should be mandated to offer government written information pamphlets on the pros and cons of mandatory arbitration versus court. Once consumers sign that they have read the pamphlet, they can decide to sign a contract that has a mandatory arbitration clause or one that does not. Perhaps the contract with a mandatory arbitration clause can be less expensive compared to the contract allowing court proceedings, since many companies believe arbitration saves them money, which is then passed onto the consumer.¹⁷⁴ This method would not only allow mandatory arbitration clauses to save some people money but it would also allow less federal or state regulation of private business practices. Procedural unconscionability would also be taken away because consumers would have real bargaining power and choice in contracts.

Due to FAA preemption and federal court splits, comprehensive action by the federal government is also necessary to protect consumers from signing away their rights to a trial. Congress should pass laws limiting the

¹⁷¹ See Burlingame, *supra* note 168, at 480. (stating that "Research has shown that because people use simplifying tools in decision-making, they: (1) display overconfidence in their ability to control future events; (2) disregard non-salient low-level probabilities of harm; and (3) discount risks whose occurrence is some time away, i.e., discounting the future phenomena, thus explaining why people have a difficult time saving for the future.").

¹⁷² See Philip P. Houle, *Eminent Domain, Police Power, and Business Regulation: Economic Liberty and the Constitution*, 92 W. VA. L. REV. 51, 103 (1989) ("In short, the free market does not require that an elite run things indefinitely until the rest of us are sufficiently enlightened to assume full adult responsibilities and rights. That patronizing view of humanity . . . manifested itself in two important ways that are hallmarks of totalitarian systems: first, the belief held by many that the state must coerce individuals into deciding to share their wealth with others, and second, the belief held by certain groups that they were anointed with the power to direct life until humanity eventually becomes better able to safely share that power.").

¹⁷³ See generally Noyes, *supra* note 81, at 1678-80.

¹⁷⁴ Cf. Sternlight & Jensen, *supra* note 163, at 93 (arguing that categorically banning class action suits save consumers money because making arbitration more favorable to consumers increases arbitration costs).

number of times a loan can be deferred at payday loan companies.¹⁷⁵ These provisions get to the heart of substantive unconscionability in a way that mandatory arbitration clauses cannot because the big problem of substantive unconscionability lies in a consumer's ability to "roll-over" loans.¹⁷⁶ Federal law should prohibit mandatory arbitration contract provisions for payday loan disputes that do not follow the cap on roll-over limitations.¹⁷⁷

The government could also give payday lending businesses a chance to institute industry-wide, self-regulated changes to lending practices in lieu of government overhaul.¹⁷⁸ This would include pressure to ban mandatory arbitration clauses. While it may be unlikely, the public outcry over the unfairness of the payday loan industry could put the industry as a whole in danger, which would be bad for the profits of the banks that sponsor payday loan companies.¹⁷⁹ In the face of being closed down entirely by governmental action, major corporations providing payday lending services may be persuaded into a self-instituted industry-wide clean-up.

B. An "Alternative" Alternative Dispute Resolution Process

As it is designed now, mandatory arbitration is unjust for disputing payday lending contracts.¹⁸⁰ Court dockets, however, are full and trials are long and expensive¹⁸¹ so the U.S. litigation system is not an efficient or

¹⁷⁵ Cf. Thomas, *supra* note 45, at 2430–31.

¹⁷⁶ *Id.*

¹⁷⁷ See *id.* at 2431.

¹⁷⁸ The idea of a self-regulated industry is not novel. The accounting industry is mostly self-regulated and while the Securities and Exchange Commission has the statutory ability to set accounting standards, it relies on the private industry to create accounting and recording standards, such as Generally Accepted Accounting Principles (GAAP). See David F. Birke, Note, *The Toothless Watchdog: Corporate Fraud and the Independent Audit - How Can the Public's Confidence Be Restored?*, 58 U. MIAMI L. REV. 891, 898–99 (2004).

¹⁷⁹ Cf. *id.* at 912 (noting that upon "the collapse of Enron and other corporate giants, Congress was forced to address public demands for greater protection from unscrupulous corporate managers.").

¹⁸⁰ See *supra* Part IV.A; Sternlight, *supra* note 1, at 1674–75 ("The bottom line: Mandatory private arbitration as we know it today in the United States is indeed unjust, both because it is imposed by a single private party and because it is private.").

¹⁸¹ Peter Lantka, *The Use of Alternative Dispute Resolution in the Federal Magistrate Judge's Office: A Glimmering Light Amidst the Haze of Federal Litigation*, 36 UWLA L. REV. 71, 73 (2005).

reasonable option in most cases.¹⁸² Since the above public policy protections will most likely never be instilled because the government is generally not protectionist,¹⁸³ a different sort of alternative dispute resolution must be considered—one that levels the playing field between payday loan borrowers and payday loan companies but is still cheap and efficient. Instead of mandatory arbitration, payday lending contract disputes should use court-sponsored facilitative mediation with a focus on procedural justice.

1. What is Court-Sponsored Mediation and How Should it be Used for Payday Lending Disputes?

Mediation entails two aggrieved parties who meet with a neutral third party (the mediator) to resolve their dispute.¹⁸⁴ If the parties come to an agreement, they may choose to make the resolution binding.¹⁸⁵ Mediation is faster and cheaper than arbitration,¹⁸⁶ which is necessary for many low-income or indigent payday loan customers. Parties are offered more control

¹⁸² Sternlight, *supra* note 1, at 1675 (“[I]n rejecting mandatory private arbitration we must not endorse our current mode of public litigation as the only just form of dispute resolution. Rather, we must continue to search for an array of dispute resolution processes that, together, will best help us achieve justice.”).

¹⁸³ David Sherwyn, J. Bruce Tracey & Zev J. Eigen, *In Defense of Mandatory Arbitration of Employment Disputes: Saving the Baby, Tossing out the Bath Water, and Constructing a New Sink in the Process*, 2 U. PA. J. LAB. & EMP. L. 73, 148 (1999) (arguing that “employee advocates perpetuate a myth of government protection when it does not exist.”).

¹⁸⁴ Around the States, *Mediation Seen as Highly Effective ADR Process*, 10 WORLD ARB. & MEDIATION REP. 31, 31 (1999) (“[T]he National Association of Securities Dealers (NASDR) is moving toward mediation as a fairer and cheaper route to dispute resolution The NASDR no longer believes that arbitration is quicker, easier, and cheaper than going to court. According to the NASD, arbitration cases can take several years to settle and hearings can take as long as 20 days in complex cases Arbitration also can be expensive because the arbitrators’ fees are based on the size of the claim. As a result of the increasing inefficiency of arbitration, the NASD is recommending mediation as a new alternative to resolving disputes.”).

¹⁸⁵ David Grappo, *Questions Litigators Ask About Mediation*, 55 DISP. RESOL. J. 2, 32–34 (2000).

¹⁸⁶ *Id.* (“It is faster because it can be set at the convenience of the parties without waiting in the court system queues. It is cheaper because the parties avoid the cumbersome court forms and procedures which are intended to protect their right to a ‘fair fight’ before an impartial judge.”).

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in mediation than they are in other forms of negotiation or litigation and this makes parties feel empowered to reach a resolution.¹⁸⁷

Court-sponsored mediation has many forms. It can be mandatory where courts are required to send certain cases to mediation or voluntary where the parties agree among themselves to mediate.¹⁸⁸ Additionally, court-sponsored mediation can simply refer parties to private mediation services, which could be expensive, or provide well trained volunteer mediators.¹⁸⁹ The kind of court-sponsored mediation that is ideal for payday lending disputes is a voluntary system where the court provides low-cost or free mediation services. This system is ideal because parties may be more likely to abide by the solution reached at the end of the mediation if it is voluntary and minimal cost or free services make mediation accessible to low income payday loan consumers.

In most court-sponsored mediation, attorneys are present to negotiate for the client.¹⁹⁰ Naturally, clients unfamiliar with legal issues give great credence to their lawyer's opinion regarding the process and solution of the mediation.¹⁹¹ Payday lending clients should have a choice of representing themselves or retaining a legal aid attorney and the court should offer free or low-cost mediation staffed with well-trained pro bono attorneys and volunteer mediators.¹⁹² The payday loan company should send a local office manager to the mediation and not a corporate attorney who could unjustly steer the mediation process. The two parties should agree on a mediator. This is important because the contract disputant will have a real choice in who acts as the neutral, which is different than mandatory arbitration where the

¹⁸⁷ Catherine Zwetkoff, *Mediation in Environmental Conflicts: The Belgian Methodology*, 9 RISK: HEALTH SAFETY & ENV'T 361, 373 (1998).

¹⁸⁸ See Dina R. Jansenson, *Alternative Dispute Resolution in the United States District Court for the Eastern District of New York*, 481 PLI/LIT 683, 698 (1993).

¹⁸⁹ See Wayne D. Brazil, *Should Court-Sponsored ADR Survive?*, 21 OHIO ST. J. ON DISP. RESOL. 241, 272 (2006).

¹⁹⁰ Jeffrey H. Goldfien & Jennifer K. Robbennolt, *What if the Lawyers Have Their Way? An Empirical Assessment of Conflict Strategies and Attitudes Toward Mediation Styles*, 22 OHIO ST. J. ON DISP. RESOL. 277, 282 (2007).

¹⁹¹ See *id.* at 285.

¹⁹² See Brazil, *supra* note 189, at 243 ("[O]ne of the very few ways a court can be useful to a substantial segment of the population is to offer a free or low-cost ADR program. By offering such a program, a court acknowledges the real-world limitations, for many people, of the services it traditionally has offered. As important, the court demonstrates that it understands that its mission is to offer useable and respect-worthy service to as large a percentage of the people who have judicially cognizable disputes as possible. This kind of acknowledgment and demonstration earn a court the gratitude and respect of the people—and gratitude toward and respect for our public institutions is essential to the long-range health of our polity.").

payday lender has contracted the power of choice.¹⁹³ Once a settlement has been reached, the parties should evaluate the mediator to make sure that court-sponsored mediators are unbiased and well-performing.¹⁹⁴ If the parties do not reach a settlement, the case should be referred to the American Arbitration Association (AAA). The AAA will assist the parties in binding arbitration through its Consumer Due Process Protocol.¹⁹⁵ The AAA does have fees for its services but those can be waived if the consumer's annual gross income falls below 200% of the federal poverty guideline.¹⁹⁶ If the consumer is not below 200% of the poverty guideline but can still not afford the service, a pro bono or reduced rate arbitrator can be appointed to the case.¹⁹⁷

The payday lending industry should agree to replace mandatory arbitration clauses with voluntary court-sponsored mediation clauses in their contracts because it will be economically beneficial for their businesses.¹⁹⁸

¹⁹³ See Hossam M. Fahmy, *Arbitration: Wiping out Consumers Rights?*, 64 TEX. B.J. 917, 918 (2001) (noting a mandatory arbitration clause in an American Express credit card contract that states American Express "has the exclusive right to choose the arbitrator. Plaintiffs do not have the same right.").

¹⁹⁴ See Vanessa Mitchell, Note, *Mediation in Kentucky: Where Do We Go From Here?*, 87 KY. L.J. 463, 470 (1999). The system used to evaluate the mediator could be used to "grade" them when they are being trained. *Id.*

¹⁹⁵ American Arbitration Association, Consumer Procedures, <http://www.adr.org/sp.asp?id=28752> (last visited May 13, 2009) ("Using its Consumer Due Process Protocol, the AAA offers administration services for disputes where there is a disagreement between individual consumers and businesses. The AAA applies the Supplementary Procedures for Consumer-Related Disputes - a supplement to the Commercial Arbitration Rules and Mediation Procedures that includes a glossary of ADR terms - when arbitration clauses exist in agreements between individual consumers and businesses where the business has a standardized, systematic application of arbitration clauses with customers and where the terms and conditions of the purchase of standardized, consumable goods or services are non-negotiable or primarily non-negotiable in most or all of its terms, conditions, features, or choices. The product or service must be for personal or household use.").

¹⁹⁶ American Arbitration Association, Administrative Fee Waivers and Pro Bono Arbitrators Services, <http://www.adr.org/sp.asp?id=22040> (last visited May 13, 2009).

¹⁹⁷ *Id.*

¹⁹⁸ T.J. Costello, *Pre-litigation Mediation as a Privacy Policy: Exploring the Interaction of Economics and Privacy*, MEDIATE.COM, April 2004, <http://mediate.com/articles/costellotjl.cfm> (last visited May 13, 2009) ("From an economic standpoint, mediation, if conducted prior to filing a formal lawsuit, is a cost-effective form of dispute resolution. Pre-litigation mediation reduces direct costs and indirect costs, saves time, and more than likely helps retain relationships Legal costs for businesses, governmental institutions and individuals alike have the potential of being burdensome and can be reduced through pre-litigation mediation.").

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Mediation is private and confidential so the payday loan industry will not have to deal with publicity or public record.¹⁹⁹ Mediation also allows the parties to design their own solution, which may be cheaper than what a judge or arbitrator decides. Additionally, if the payday loan companies use local representatives, cost will be cheaper than arbitration, which generally requires attorneys, whereas mediation does not.²⁰⁰ Further, the resolution of cases is faster through mediation versus arbitration because there is no waiting for the arbitrator to research and write a decision.²⁰¹

One drawback to mediation that may be especially relevant to payday loan contract disputes is that power differentials between the parties can influence the mediation.²⁰² This has been remedied in many jurisdictions by requiring mediators to be certified²⁰³ or abide by a code of professionalism that guarantees a fair and neutral process.²⁰⁴ Court sponsored mediation may also be unfair if a mediator tries too hard to settle a case.²⁰⁵ In order to ensure the mediator does not push unfair settlement, facilitative mediation should be used in solving payday lending disputes.

2. What is Facilitative Mediation and Why is it Good for Payday Lending Disputes?

The chosen neutral should use a facilitative mediation style for the payday lending dispute. In facilitative mediation, mediators use processes

¹⁹⁹ This is good for the industry although it may not be good for precedent or society in general. See Brenowitz, *supra* note 94, at 680.

²⁰⁰ Nancy C. House, *Grievance Mediation: AT&T's Experience*, 43 Lab. L.J. 491, 494 (1992), available at http://www.mrep.org/mediation/books_articles/house_article.htm ("In addition to the lower cost for mediators as opposed to arbitrators (resulting from less time spent, not from any material difference in daily fees), there are also no attorney fees, no court reporter or transcript, no hotel conference facilities, and no witness expenses I understand that the average cost for mediating a single grievance for many companies is around \$350. For AT&T, the average cost is considerably higher than that since our labor managers must travel from Atlanta to wherever the grievant is located. Our figure is around \$900. However, this is still much cheaper than arbitration, which for us requires an attorney from New Jersey and a labor manager from Atlanta for both preparation and hearing time.").

²⁰¹ *Id.*

²⁰² See Zwetkoff, *supra* note 187, at 373.

²⁰³ See Sharon Press, *Institutionalization: Savior or Saboteur of Mediation?*, 24 FLA. ST. U. L. REV. 903, 909-12 (1994).

²⁰⁴ Zwetkoff, *supra* note 187, at 373.

²⁰⁵ Martin A. Frey, *Does ADR Offer Second Class Justice?* 36 TULSA L.J. 727, 759 (2001).

that assist parties in arriving at their own resolution and refrain from presenting their own ideas on the case.²⁰⁶ Facilitative mediators assume that parties can collect their own information so their primary role is to help parties communicate with each other and agree on a solution.²⁰⁷ The facilitative model is in contrast to the evaluative model of mediation where mediators add their own views on the strengths and weaknesses of the parties' positions and may provide a legal assessment of the claim.²⁰⁸

Facilitative mediation is ideal for payday lending disputes because people generally prefer this mode of mediation over adjudicative models.²⁰⁹ In particular, people favor a facilitative method because it consigns neutrals to simply facilitating the disputants in coming to their own ideas for resolution.²¹⁰ The facilitative process can be used without a lawyer representing the payday loan customer because the lawyer cannot necessarily voice the concerns of the client precisely and having a voice is essential to feeling as though the mediation process was fair.²¹¹ In fact, disputants who consider themselves to be of a lower social status did not indicate a preference for the help of a representative.²¹²

A possible con to facilitative mediation is that the parties will not receive information from the mediator about how the case might be resolved in litigation or the substantive law that governs the dispute the parties will be guided in resolving the problem on their own.²¹³ Facilitative mediation could also be too passive and inefficient as compared with other methods of dispute resolution.²¹⁴ Additionally, the decision the parties agree to could be contrary to standards of fairness and mediators may not have the ability to protect the

²⁰⁶ See Donna Shestowsky, *Procedural Preferences in Alternative Dispute Resolution: A Closer, Modern Look at an Old Idea*, 10 PSYCHOL. PUB. POL'Y & L. 211, 224 (2004).

²⁰⁷ Cris M. Currie, *Mediating Off the Grid*, 59 DISP. RESOL. J. 9, 10 (2003).

²⁰⁸ Shestowsky, *supra* note 206, at 224.

²⁰⁹ *Id.* at 245–46. In fact, only 10% of the people who participated in a study where they took part in different types of mediations and arbitrations preferred a different method better than a facilitative method. "In particular, because these configurations suggest a preference for relegating third parties to assisting the disputants in arriving at their own ideas for resolution (common in facilitative mediation) rather than proposing resolutions that the disputants can then either accept or reject (common in evaluative mediation), they suggest a preference for the facilitative form of mediation." *Id.* at 245.

²¹⁰ *Id.*

²¹¹ Nancy A. Welsh, *Making Deals in Court-Connected Mediation: What's Justice Got to Do with It?*, 79 WASH. U. L.Q. 787, 840–41 (2001).

²¹² Shestowsky, *supra* note 206, at 247.

²¹³ See *id.* at 225.

²¹⁴ Currie, *supra* note 207, at 10.

weaker party.²¹⁵ These disadvantages can be remedied by mediation sessions that concentrate on procedural justice.

3. *Court-Sponsored Mediation of Payday Loan Disputes Should Concentrate on Procedural Justice*

Since the mediation process is more flexible than the arbitration process, the mediator should focus on procedural justice more than distributive justice. "Procedural justice is concerned with the fairness of the procedures or processes that are used to arrive at outcomes" in contrast with distributive justice, which "focuses on perceptions of and criteria to determine the substantive fairness of the outcomes themselves."²¹⁶ A person's perception about the fairness of the procedure affects their judgment about the distributive outcome, their willingness to comply with the outcome, and their confidence in the legitimacy of the institution that offered the mediation.²¹⁷ The legitimacy aspect is especially important when mediation is connected to courts, since the authority of the court is based on its legitimacy in the eyes of the public.

Procedural justice is imperative to payday loan customers who want to tell their story. Research has shown that disputants believe the outcome of the mediation is just when they are allowed to tell their story to a neutral party who considers the story with respect and makes a rational decision based on both sides of the disputants' accounts.²¹⁸ Offering a voice to payday loan victims will make them feel as though the court system and mediation respects their value as people, which is important to feeling as though justice has been served no matter the outcome.²¹⁹

An additional way to instill procedural justice into court-sponsored mediation besides allowing the disputants to have a voice and following facilitative mediation methods is to dispose of caucuses and concentrate on

²¹⁵ Zena D. Zumeta, *Styles of Mediation: Facilitative, Evaluative and Transformative Mediation*, <http://learn2mediate.com/resources/naefcm.php#procon>. (last visited May 13, 2009).

²¹⁶ Welsh, *supra* note 211, at 817.

²¹⁷ *Id.*

²¹⁸ *See id.* ("Disputants use the following indicia to assess procedural justice: whether the procedure provided them with the opportunity to tell their stories, whether the third party considered their stories, and whether the third party treated them in an even-handed and dignified manner. The procedures used in socially-sanctioned dispute resolution processes assume such significance because disputants seek personal and pragmatic reassurance. Disputants need to believe . . . that the final outcome of a dispute resolution process will be based on full information.").

²¹⁹ *Id.* (noting that disputants need to know they are valued members of society).

joint sessions.²²⁰ When neutrals meet only with one party at a time in separate consecutive caucuses, the mediation is apt to turn into deal-brokering instead of a fair process for both sides.²²¹ Initial joint-meetings can be uncomfortable but disputants are more reassured that an outcome is fair when they are able to interact with the mediator face-to-face and make sure that the neutral is getting accurate information from both sides.²²²

In procedural justice, the over-riding concentration is on allowing the disputants to tell their story, which can lead to more creative outcomes than simply money damages.²²³ A discussion of each disputant's essential interests and wishes makes it more likely that unique and non-money agreements will be reached.²²⁴ Even if monetary compensation is the method of justice that is agreed upon by the parties (which is most likely in payday loan contract disputes), the parties will feel as though they have "experienced justice."²²⁵ A focus on procedural justice is ideal for payday loan contract disputes because consumers will be offered a dispute resolution method that they can afford, have a choice in, and feel as though they have been served justice in the end.

VII. CONCLUSION

Mandatory arbitration clauses in payday lending contracts allow consumers to sign away their right to a public trial in front of their peers for private arbitration sessions where the final decision is made by a company chosen arbitrator. These arbitration clauses decrease faith in the dispute resolution system and harm unsophisticated borrowers. Since it is unlikely that Congress or the federal court system will come up with a proficient answer in the near future, consumers need protection now. As such, payday loan contract disputes should go to court-sponsored mediation instead of private mandatory arbitration.

²²⁰ *Id.* at 851.

²²¹ *Id.* at 852.

²²² *See* Welsh, *supra* note 211, at 852.

²²³ *See id.* at 855–56.

²²⁴ *Id.* at 856.

²²⁵ *Id.*