Developments in Class-Action Law

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■ Introduction

Reverberations from the passage of Proposition 64, the California Supreme Court's decision in *Discover Bank v. Superior Court of Los Angeles County*, 36 Cal. 4th 148 (2005), and, of course, the enactment of the federal Class Action Fairness Act, continue to impact the class action bar, making the past year one of dramatic changes in class action litigation practice.

Aside from the Class Action Fairness Act (discussed in the last issue), the California Supreme Court's decision in *Discover Bank* is probably the most significant recent development in class-action law. In *Discover Bank*, the Court held that contractual waivers on class actions may be unconscionable under certain circumstances. Subsequent appellate decisions, however, demonstrate that contractual waivers of the right to bring a class action are not unconscionable in every instance. According to these appellate cases, the unconscionability of a class action waiver depends on whether it is an adhesion contract presented on a "take it or leave it basis," whether there is a scheme to cheat large numbers of consumers out of small sums of money and whether the contract has an effective choice-of-law provision.

In another significant development, the California Supreme Court granted review in a number of cases to decide whether Proposition 64, which adds the requirement of "injury in fact" standing to claims brought pursuant to the Unfair Competition Law ("UCL") and False Advertising Statute ("FAS"), applies to pending cases. If deemed retroactive, Proposition 64 would significantly impact pending cases because it would require plaintiffs who filed UCL and FAS claims on behalf of the general public *before* the enactment of Proposition 64 to meet the new standing requirement not present when they filed suit.[1] As a result, many pending cases could be dismissed. But, if the California Supreme Court concludes that Proposition 64 applies to pending cases, it will also decide whether plaintiffs who have not met the new standing requirement can amend their complaints to add a new representative plaintiff who does.

Similarly, federal courts have addressed the issue of what conduct "commences" an action for purposes of the Class Action Fairness Act ("CAFA"), Pub. L. No. 109-2, 119 Stat. 4. CAFA, which changes federal court jurisdiction over class actions, specifically states that it applies only to actions commenced on or after February 18, 2005, its effective date. Courts, however, also have considered whether removal itself "commences" an action under CAFA and whether an action "commences" under CAFA when a plaintiff amends the complaint at some point after CAFA's effective date. Federal courts have *agreed* that state law defines when an action commences. In California, an action commences when the complaint is filed in state court, not when it is removed. Although the Ninth Circuit has not yet decided whether an amendment "commences" a new action, the Seventh Circuit provides guidance, as does a recent California Court of Appeal decision.

Finally, within the last year, the California Court of Appeal held that opt-in classes are not permitted in California, courts can shift the burden of paying for class notice to defendants, and employees or attorneys associated with class counsel cannot act as class representatives because of the perceived conflict of interest.

1. Proposition 64 also requires plaintiffs bringing UCL and FAS claims on behalf of the general public to meet the requirements of C.C.P. §382. Whether this means plaintiffs must actually certify UCL and FAS claims brought on behalf of the general public as class actions is still debatable.

■ Class Action Waivers are Generally, But Not Always, Unconscionable

Last year, the California Supreme Court determined that clauses waiving a party's right to bring class actions may be unconscionable and therefore unenforceable under certain circumstances. Specifically, the California Supreme Court held that class action waivers in consumer contracts of adhesion are unconscionable where they involve small amounts of damages and where the plaintiff alleges the party with superior bargaining power carried out a scheme to deliberately cheat large numbers of consumers out of small sums of money.[2] Subsequent appellate decisions, however, demonstrate that waiver clauses will not be found unconscionable in all circumstances.

In *Discover Bank*, plaintiff brought a class action complaint for breach of contract and violation of the Delaware Consumer Fraud Act against the defendant bank. Plaintiff alleged that the bank had a practice of representing that it would not charge a late fee if the bank received payment by a certain date, but then it assessed a fee if it received payment after 1:00 p.m. on that date.[3] The bank moved to compel arbitration on the plaintiff's individual claims and to dismiss the class action pursuant to an arbitration clause in the credit card agreement that presumably forbade classwide arbitration. This provision was not in the original agreement, but imposed by a notice that the bank sent to customers with their monthly bill.[4] Plaintiff opposed the motion on grounds that the class action waiver was unconscionable and unenforceable under California law.[5]

The trial court agreed with plaintiff and denied the bank's motion. The trial court also conducted a choice of law analysis and concluded that enforcing such waiver under Delaware law would violate a fundamental public policy under California law.[6] The Court of Appeal reversed the trial court's order, but on a different ground. Not taking issue with the class action waiver being unconscionable, the Court of Appeal concluded that the Federal Arbitration Act ("FAA") preempted any California rule prohibiting class action waivers.[7] The California Supreme Court, in turn, rejected the Court of Appeal's decision.

According to the California Supreme Court, the FAA, which prevents laws that discriminate against arbitration clauses, does not preempt a California law prohibiting class action waivers because the principle that class action waivers are unconscionable applies to all contracts, not merely arbitration agreements.[8]

The California Supreme Court then held that the class action waiver was unconscionable under California law because it was both procedurally and substantively unconscionable.[9] The Court found an element of procedural unconscionability present "when a consumer is given an amendment to his cardholder agreement in the form of a 'bill stuffer' that he would deem to accept if he did not close his account."[10] Moreover, an adhesion contract may be substantively unconscionable if it has "exculpatory contract clauses that are contrary to public policy."[11] According to the Court, class action and arbitration waivers act as exculpatory clauses because damages in a consumer case are small, and a company's profits are large, meaning "the class action is often the only effective way to halt and redress such exploitation."[12] The Court

2. *Discover Bank*, 36 Cal. 4th at 162.
3. *Id.* at 154.
4. *Id.*
5. *Id.*
6. *Id.* at 155.
7. *Id.* at 155.
8. *Id.* at 167.
9. *Id.* at 160-61.
10. *Id.* at 160.
11. *Id.* at 161.
12. *Id.*

also found that even though such waivers are crafted as a mutual prohibition, they are, in fact, one-sided because credit card companies rarely sue their customers in class action lawsuits.[13] Thus, the California Supreme Court held the bank's waivers were unconscionable because "the waiver becomes in practice the exemption of the party 'from responsibility for [its] own fraud, or willful injury to the person or property of another.'"[14]

Nevertheless, the Court also made clear that if a choice of law provision effectively invokes the law of another state, California's unconscionability principles may not apply.[15] Thus, because the Court of Appeal had not addressed the choice of law issue, the Supreme Court remanded the case to the appellate court for determination of whether the Delaware choice-of-law provision in the credit card agreement requires the enforcement of class action waivers.[16]

On remand, the Court of Appeal found the class action waiver was indeed enforceable under Delaware law.[17] The court in *Discover Bank II* applied §187, subdivision (2) of the *Restatement Second of Conflict of Laws*, which governs the enforcement of a contractual choice-of-law provision in California. The *Restatement* offers a three part test to determine which state's law applies. First, the court has to determine "whether the chosen state has a substantial relationship to the parties or their transactions, or [ ] whether there is any other reasonable basis for the parties' choice of law."[18] If neither test is met, then California law applies. But, if either test *is* met, then the court must determine whether the chosen state's law "fundamentally" conflicts with California law. If not, then the court shall apply the chosen state's law. If there is a conflict, however, "the court must then determine whether California has a 'materially greater interest than the chosen state in the determination of the particular issue.'"[19] If so, the court will apply California law.[20]

According to the Court in *Discover Bank II*, Delaware has a "substantial relationship" with the bank because it is domiciled in Delaware and a Delaware statute specifically requires that Delaware law govern agreements between Delaware banks and borrowers. Therefore, applying California's choice of law test, Delaware law applies unless plaintiff can show: (1) that applying Delaware law to determine the enforceability of the class action waiver would contravene a fundamental policy of California; and, (2) California has a materially greater interest than Delaware in determining the issue. The Court of Appeal concluded that California did not have a materially greater interest than Delaware: "Delaware's interest is demonstrably greater than California's because (1) Delaware is home to the sole defendant, not just (like California) home to some portion of the putative class, (2) Delaware has demonstrated by statute its concern that Delaware law should apply to claims between Delaware banks and their cardholders, and (3) [plaintiff] is asserting claims under Delaware law alone."[21] As a result, the appellate court declined to determine whether enforcing Delaware law would contravene a fundamental policy of California.

Subsequently, in *Aral v. Earthlink, Inc.*, 134 Cal.App.4th 544 (2005), the Court of Appeal found both a contractual ban on class arbitration and a forum selection clause requiring individual arbitration in Georgia unconscionable. In *Aral*, plaintiff brought a UCL claim on behalf of California residents against Earthlink challenging its

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13. *Id.*
14. *Discover Bank*, 36 Cal.4th at 162-63.
15. *Id.* at 173.
16. *Id.*
17. *See Discover Bank v. Superior Court* ["*Discover Bank II*"], 134 Cal.App.4th 886 (2005).
18. *Id.* at 891.
19. *Id.*
20. *Id.*
21. *Id.* at 895.

practice of charging customers for DSL services before Earthlink delivered the necessary equipment.[22] Earthlink petitioned to compel arbitration under the DSL service agreement sent with the installation kit. The service agreement precluded classwide arbitration and compelled individual arbitration to be held in Georgia.[23] The appellate court however, ruled the class action waiver unconscionable because, as in *Discover Bank*, Earthlink presented the terms of the agreement on a "take it or leave it" basis with no opportunity to opt out, which is "quintessential procedural unconscionability."[24] The Court also found the class action waiver substantively unconscionable because the complaint alleged that "numerous consumers were cheated out of small sums of money through deliberate behavior."[25]

Further, the Court found "unreasonable" the forum selection clause requiring its customers to travel to Georgia to arbitrate claims to recover a small sum on a case-by-case basis.[26] According to the Court, although "Earthlink has a substantial relationship to Georgia and a reasonable basis for choosing Georgia law since its principle place of business is there [] Aral resides in California, seeks to represent only California consumers, and relies solely on California's UCL to support his claim. The fundamental policy at issue is not simply the right to pursue a class action remedy, but the right of California to ensure that its citizens have a viable forum in which to recover minor amounts of money allegedly obtained in violation of the UCL. Forcing consumers to travel to a far location and depriving them of any hope of class litigation would pose an insurmountable barrier to recovery of small sums unjustly obtained, and undermine the protections of the UCL. There is no doubt that California has a 'materially greater interest than [Georgia] in the determination of [this] particular issue....'"[27]

The Court of Appeal also found the class action waiver unconscionable in *Klussman v. Cross Country Bank*, 134 Cal. App. 4th 1283 (2005). There, plaintiffs filed a class action complaint on behalf of the bank's California credit card customers challenging a number of alleged unlawful practices, such as misrepresenting payoff charges and imposing unauthorized fees.[28] The bank filed a motion to compel arbitration under the cardholder agreement, which required claims to be brought in arbitration before the National Arbitration Forum ("NAF") and to be governed by the FAA and Delaware law.[29] Like the arbitration provision at issue in *Discover Bank*, the arbitration provision was not part of the original agreement, but included by a separate notice.[30] Plaintiffs opposed defendants' motion, arguing that the arbitration clause was unenforceable because it had the effect of precluding class actions, as NAF rules prohibited classwide arbitration unless all parties consented.[31] The court agreed and found the class action waiver unconscionable and, therefore, unenforceable.[32]

Moreover, the *Klussman* court found California law applied *despite* a Delaware choice of law provision. According to the court, California had a "materially greater interest" than Delaware because unlike *Discover Bank II*, plaintiffs were California residents, received their credit cards in California, used their cards in California, paid their bills from California and the bank harassed them at their homes and jobs in California. Moreover, the court explained that

22. 134 Cal.App.4th at 550.
23. *Id.*
24. *Id.* at 557.
25. *Id.*
26. *Id.* at 561.
27. *Id.* at 564.
28. 134 Cal.App.4th at 1287.
29. *Id.* at 1288.
30. *Id.*
31. *Id.* at 1289.
32. *Id.*

California has a greater interest than Delaware because plaintiffs invoked primarily California laws, including laws expressing the public policy of protecting consumers, and sought to represent California residents with California statutory claims. Finally, the Court stated, "California's interest becomes even more intense when it is protecting its citizens from 'take it or leave it' agreements that incorporate one sided protections and impose hidden waivers without actual notice or a realistic opportunity to reject the waiver."[33]

In contrast, in *Gentry v. Superior Court*, 135 Cal.App.4th 944 (2006), the Court of Appeal found a class action waiver in defendant's arbitration agreement neither procedurally nor substantively unconscionable. In *Gentry*, the plaintiff alleged that Circuit City misclassified him and other customer service managers as "exempt managerial / executive employees" not entitled to overtime pay, when in fact they were not exempt. During his employment, plaintiff received a packet that included an arbitration agreement containing a class action waiver, with a form providing him with 30 days to opt out of the arbitration agreement.[34] According to the court, unlike the agreement in *Discover Bank*, Circuit City's agreement was not procedurally unconscionable because it was not a condition of employment, and the plaintiff was given 30 days to opt out.[35] The court also did not find the agreement substantively unconscionable because unlike the situation in *Discover Bank*, where the disputes involved small amounts of damages or where there was a scheme to cheat large numbers of consumers out of small amounts of money, here the named plaintiff had the potential to recover "substantial damages and penalties" for his individual claims.[36]

Similarly, in *Jones v. Citigroup, Inc.*, 135 Cal.App.4th 1491 (2006), the court did not find a change of terms notice to a credit card agreement forbidding class wide arbitration procedurally unconscionable because the notice allowed a card holder to "opt out." In *Jones*, the plaintiffs filed a class action complaint under the UCL, claiming that defendants failed to make required disclosures about finance charges and interest rates.[37] Defendants filed a motion to compel arbitration based on an arbitration clause that had been made part of the credit card agreement through a change-in-terms notice.[38] The arbitration provision included a class action waiver, and advised customers that they could opt out of the arbitration provision by providing notice within 26 days after the Statement/Closing date. If a consumer opted out, they would have until the expiration date printed on their card to use their card under the existing terms.[38] The Court of Appeal concluded that the arbitration provision was not procedurally unconscionable because the arbitration provision was not presented on a "take it or leave it" basis. Instead, plaintiffs were given an opportunity to opt out of arbitration and could use their cards until it expired.[39] "In sum, plaintiffs cited no law, and we found none, that holds use of a change of terms notice included with a billing statement where the bill itself prominently states the agreement is being amended, and regardless of its terms, is unconscionable."[40]

Based on the cases regarding contractual class action waivers, it appears the current rule is that such waivers will be found unconscionable under California law if they are presented on a "take it or leave it basis," are designed to cheat a large number of consumers out of small sums of money and there is not an effective choice-of-law provision in the contract that would render another state's law controlling.

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33. *Id.* at 1299.
34. 135 Cal.App.4th at 947.
35. *Id.* at 949.
36. *Id.* at 951.
37. 135 Cal.App.4th at 1493.
38. *Id.* at 1493-94.
39. *Id.* at 1494-95.
40. *Id.* at 1497-98.

■ CAFA

On February 18, 2005, the President signed CAFA into law. Although CAFA has a clause that explicitly states it only applies to actions commenced on or after its effective date, litigation ensued across the country regarding the meaning of the word "commence." Federal courts agree that state procedural law determines when an action commences for CAFA purposes.

In October 2005, the Ninth Circuit held that an action "commences" for purposes of CAFA when the complaint is filed, not when it is removed to federal court.[42] The Ninth Circuit, however, has not yet addressed whether an amendment to a complaint "commences" a new action for CAFA purposes. But other courts suggest that it depends on the specific facts of the case and a careful relation-back analysis. For example, according to the Seventh Circuit, an amendment adding or substituting a named plaintiff may not commence a new action, because substituting unnamed class members is "routine" in class action litigation.[43] But, where a complaint is amended to add new claims or defendants, a new action may "commence" for purposes of CAFA if the amendment does not relate back to the original complaint.[44]

The California Court of Appeal decision in *Shapell Industries, Inc. v. Superior Court of Los Angeles County*, 132 Cal. App. 4th 1101 (2005), provides guidance as to whether amendments will be deemed to "commence" new actions under CAFA. In *Shapell*, the Court of Appeal found that a class action continues to exist even after a plaintiff is dismissed. This suggests that under California procedural law, amending a complaint to add a new plaintiff will not be deemed to have commenced a *new* action for purposes of CAFA—at least when that addition is a routine substitution.

In *Shapell*, the plaintiff brought class and individual claims, but voluntarily dismissed his individual causes of action.[45] Following dismissal of those claims, the court granted plaintiff's request for leave to amend the complaint to add a new representative plaintiff.[46] The defendant argued that the trial court lacked subject matter jurisdiction to grant such a request because the original plaintiff dismissed the entire action by dismissing himself as a party.[47] The Court disagreed. According to the appellate court, dismissal of the entire action "would have constituted an abuse of discretion where the court had not found that the complaint failed to properly allege a community of interest among the proposed class members."[48] Even though there was no longer a named plaintiff of the putative class, the court found that "[t]he alleged putative class members are the parties interested in prosecuting the action, such that an actual, justifiable controversy exists, pending amendment to add a named representative plaintiff."[49] The court reasoned that "California courts recognize and preserve the rights of absent class members, even before the issue of certification has been determined."[50] Thus, the court in Shapell found the new representative plaintiff to be "a party interested in the action, by virtue of his membership in the uncertified class, at the time [the original plaintiff] dismissed himself out, rendering [his] dismissal only a partial one."[51]

Thus, for purposes of CAFA, in California, amending a complaint to substitute a new class

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41. *Id*. at 1498.
42. *Bush v. Cheaptickets, Inc*., 425 F.3d 683 (9th Cir. 2005).
43. *Phillips v. Ford Motor Company*, 435 F.3d 785, 787 (7th Cir. 2006).
44. *Knudsen v. Liberty Mutual Ins. Co.*, 435 F.3d 755, 758 (7th Cir. 2006).
45. *Id*. at 1107.
46. *Id*. at 1106.
47. *Id*. at 1104.
48. *Id*. at 1110.
49 .*Id*. at 1110-11.
50. *Id*. at 1109.
51. *Id*. at 1111.

representative when the original one can no longer serve does not commence a new action.

■ Proposition 64

The approval of Proposition 64 by voters on November 3, 2004, has prompted much debate throughout the California courts regarding whether the requirements of Proposition 64 applies to pending cases. On April 27, 2005, the California Supreme Court granted review in five cases in order to decide this issue.[52] The Court also subsequently granted review in a number of other cases.[53] If the Court finds Proposition 64 is retroactive, it will likely also decide whether plaintiffs will be permitted to amend their complaints to add a plaintiff who meets the Proposition 64 requirements. Still under debate is whether meeting the requirements of C.C.P. §382 means actually certifying the class. The California Supreme Court is likely to address this issue in the future as well, although that issue is not before the Court in the aforementioned cases.

■ Opt-In Classes and Cost Shifting

The Court of Appeal also addressed the issue of opt-in classes last year in *Hypertouch, Inc. v. Superior Court*, 128 Cal. App. 4th 1527 (2005). In *Hypertouch*, because the trial court ordered personal notice to members of the certified class and because they could not be identified, the trial court ordered publication notice and required members to "opt-in" for inclusion in the class.[54] Plaintiff sought a writ of mandate, claiming that imposing an opt-in requirement defeats the purposes of class actions, the goals of judicial economy, and is not constitutionally required.[55] The Court of Appeal agreed. According to the appellate court, an "opt-in" requirement undermines the integrity of the class action process "because it invariably decreases the number of class members bound by the judgment and thereby increases the likelihood of redundant litigation."[56] As a result, the appellate court remanded the case and directed the trial court to vacate its order and enter a new order that did not require members of the certified class to "opt-in."[57]

In addition, the appellate court in *Hypertouch* stated that though it is ordinarily plaintiff's burden to provide and pay for notice to the class, a court can shift that responsibility to the defendant when that defendant's conduct may have unnecessarily complicated the problems of identifying and notifying the class or when the defendant possesses the ability to provide class notice easily and at relatively little cost.[58] This is significant because it provides a basis for requiring corporate defendants—who have access to class member information—to pay for the cost of notice when they refuse to provide this information to plaintiffs.

■ Counsel-Related Plaintiff as Class Representative

The issue of whether a law firm could serve as counsel when the class representative was an employee of the law firm came before the Court of Appeal this past year. In *Apple Computer, Inc. v. Superior Court*, 126 Cal. App. 4th 1253 (2005), the class representative was represented by two law firms. He was employed by one firm and the other firm had acted as co-counsel

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52. *See Californians for Disability Rights v. Mervyn's, LLC*, 126 Cal.App.4th 386 (2005); *Branick v. Downey Savings & Loan Assn.*, 126 Cal. App.4th 828 (2005); *Benson v. Kwikset Corp.*, 126 Cal.App.4th 887 (2005); *Bivens v. Gallery Corp.*, 134 Cal.App.4th 847 (2005); *Lytwyn v. Fry's Electronics, Inc.*, 126 Cal.App.4th 1455 (2005).
53. *See Thornton v. Career Training Center, Inc.*, 128 Cal.App.4th 116 (2005); *Schulz v. Neovi Data Corp.*, 129 Cal.App.4th 1 (2005); *Consumer Advocacy Group, Inc. v. Kintetsu Enterprises of America*, 129 Cal.App.4th 540 (2005); *Huntington Life Sciences, Inc., v. Stop Huntington Animal Cruelty USA Inc.*, 129 Cal.App.4th 1228 (2005) (Currently, this is the only published case discussing the issue of Proposition 64 retroactivity); *Schwartz v. Visa International Service Ass'n*, 132 Cal.App. 1452 (2005).
54. 128 Cal.App.4th at 1549.
55. *Id.*
56. *Id.* at 1550.
57. *Id.* at 1551.
58. *Id.* at 1553-54.

with his employer in a number of other cases. The defendant sought to disqualify both firms on the basis that they had a conflict of interest with the putative class. "As the class representative, plaintiff is obligated to seek the maximum recovery for the putative class, but plaintiff and the firms may have an interest in maximizing their recovery of attorney fees."[59] Citing a number of federal cases, the Court of Appeal held that a law firm could not serve as class counsel when the class representative was an employee of the firm or where the law firm serves as co-counsel with the class representative's law firm in other cases.[60]

59. 126 Cal.App.4th at 1261.
60. *Id.*