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Evaluating 'Loser Pays' Clauses In Arbitration Agreements

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Several recent judicial decisions have considered the validity of “loser pays” and cost-shifting clauses in arbitration agreements. The most compelling arguments have invoked unconscionability and overriding public policy considerations. Even where courts have rejected those arguments, their decisions reveal how to successfully attack “loser pays” and cost-shifting clauses that may be subject to severance before arbitration begins. They also provide some guidance for companies that want to enforce them as written.

The Eleventh Circuit in Larsen v. Citibank FSB, recently considered whether a “loser pays” clause in a bank depositor agreement was substantively unconscionable under Washington law.[1] Substantively unconscionable contract terms have been described as: “one-sided,” “shocking to the conscience,” “overly harsh,” "monstrously harsh,” or “exceedingly calloused.”[2] The plaintiff claimed that the arbitration provision was substantively unconscionable because the cost of the arbitration could be reallocated entirely to him if he did not prevail.[3]

The agreement required depositors to arbitrate all claims before the American Arbitration Association (AAA) or Judicial Arbitration and Mediation Services Inc. (JAMS).[4] JAMS has a consumer arbitration policy, which strictly prohibits the reallocation of arbitration costs and fees to consumers.[5] The AAA commercial rules do not contain a similar policy or rule. The commercial rules allow an arbitrator to reallocate the costs of arbitration in her discretion.[6] The Eleventh Circuit explained that the consumer in Larsen could have chosen to arbitrate before JAMS, thereby avoiding the cost-shifting risk.[7] Under JAMS’s consumer arbitration policy, the consumer’s costs would have been limited to the $250 filing fee (and his own attorney’s fees).[8] The consumer therefore could eliminate the risk of cost-shifting under the agreement’s plain terms by simply choosing JAMS as the arbitration forum.[9] As such, there was no risk that cost-shifting would effectively chill his willingness to bring claims against the defendant. The court therefore held that the “loser pays” clause was not substantively unconscionable.

For different reasons, a district court in Colorado rejected a claim that an arbitration agreement was per se unenforceable because it mandated proceeding under the AAA commercial rules and contained an attorney fee-shifting clause. In Daniels v. Encana Oil & Gas (USA) Inc., decided on Aug. 1, 2017, a former employee contended that he could not bear the financial burden of prosecuting his Fair Labor Standards Act claim under the AAA commercial rules and an attorney fee-shifting clause contained in the arbitration agreement.[10]

The district court considered whether the AAA commercial rules and a mandatory attorney fee-shifting clause prohibited the plaintiff from effectively vindicating his claims. The effective vindication doctrine exists to prevent the prospective waiver of a litigant's right to pursue statutory remedies.[11] It may be applied in cases where large arbitration costs could preclude a litigant from prosecuting federal statutory claims.[12] The policy underlying the doctrine allows courts to consider whether a litigant's inability to pursue her statutory rights and remedies should outweigh the strong presumption in favor of compelling arbitration.

Based upon the facts before it, the district court explained: (1) it had authority to decide the enforceability of an arbitration agreement if it implicates the effective vindication doctrine despite the strong preference to enforce arbitration agreements; and (2) an arbitration agreement that invokes the AAA commercial rules implicates the effective vindication doctrine even if the wording of the arbitration agreement itself does not.[13] It explained further that it is within the court's power to consider the arbitrability of a claim and to consider "whether legal constraints external to the parties' agreement foreclosed the arbitration of statutory claims."[14]

The district court was not, however, willing to invalidate the entire arbitration agreement under the effective vindication doctrine. Indeed, it explained that an arbitration agreement may not be "completely obliterated" because one or more provisions deny a plaintiff the right to effectively vindicate a claim.[15] "[W]here a contract contains a void arbitration provision it must either be deemed unenforceable where there is no savings clause to the contract or, in keeping with the presumption in favor of arbitrability in the case of a contract with a savings clause, the void language may be stricken and the arbitration agreement otherwise enforced."[16]

Accordingly, the district court in Daniels ordered the plaintiff to show cause as to the financial hardship he would incur if compelled to proceed under the arbitration agreement — i.e., under the AAA commercial rules and the attorney fee-shifting provision.[17] It further held: "If, but only if, Plaintiff can show that enforcing the arbitration agreement in its entirety would be so prohibitively expensive that it would effectively prevent him from vindicating his rights, then the court will sever any problematic provisions of the arbitration agreement and direct the arbitrator to ignore them."[18]

Similarly, in Valerio Sanders v. JGWPT Holdings, decided on Sept. 27, 2017, the plaintiffs (individuals who sold their annuities to a company for a discounted present cash value), contended that the cost-shifting provision in their arbitration agreements was unconscionable under Illinois law.[19] They "hypothesize[d] that they could end up winning on some claims but remain required to pay the substantially prevailing [respondent's] fees and expenses."[20] The district court first noted that the cost-shifting provision applied equally to both sides.[21] It then explained that the plaintiffs only speculated that the cost-shifting provision would be unfair to them, which is insufficient to show unconscionability.[22] The court held that the plaintiffs failed to provide "individualized evidence that [they] likely will face prohibitive costs in the arbitration at issue and that [they] are financially incapable of meeting those costs."[23]

Unlike in Daniels, the plaintiffs in Valerio Sanders, did not contend that the arbitration agreement's requirement that they proceed under the AAA commercial rules was substantively unconscionable. The district court therefore did not consider the issue. Rather, its analysis focused on the cost-shifting provision as written and the evidence the plaintiffs offered to support its unconscionability claim. It ultimately compelled the plaintiffs to arbitrate all claims under the arbitration agreement and dismissed the case.[24]

State public policy also may jeopardize "loser pays" clauses. In a recent case brought under a state consumer protection statute, an Ohio appellate court held that "loser pays" clauses deter consumers from pursuing their rights against suppliers and are unenforceable as a matter of Ohio public policy.[25] The court's opinion essentially applied the effective vindication doctrine without identifying it.

In Gaither v. Wall & Associates LLC, the plaintiff contracted with the defendant for tax relief services. Their agreement contained an arbitration clause, which included the "loser pays" provision. The "loser pays" provision required the losing party to pay costs and attorney's fees.

The court explained that "contracts which bring about results which the law seeks to prevent are unenforceable as against public policy."[26] "This rule stems from the … legal principle which declares that no one can lawfully do that which has the tendency to be injurious to the public welfare."[27] It reasoned that the form of "loser pays" provision contained in the defendant's contract "attempts to modify or rewrite the rule for attorney fees under the OCSPA, which allows a prevailing party to be awarded attorney fees only where a consumer's action is groundless or in bad faith, or where a supplier knowingly commits an act or practice that violates the CSPA [Consumer Sales Practices Act]."[28] It accepted the reasoning of the Eighth District in DeVito and in Hedeen v. Autos Direct Online Inc., that "an arbitration agreement violated public policy to the extent it required an arbitrator to award the prevailing party reasonable attorney fees even where the consumer did not file the action in bad faith."[29] "The CSPA reflects a strong public policy that consumers who bring good faith claims against suppliers will not have to pay the supplier's attorney fees under R.C. 1345.09(F), even if the consumer loses his or [her] claim against the supplier."[30] In the consumer context, a "loser pays" provision "effectively nullifies [the] statutory protection provided to consumers by the CSPA."[31]

In reaching its decision, the court relied on an established body of Ohio case law that emphasizes the role of the OCSPA as a remedial statute "designed to compensate for traditional consumer remedies."[32] It explained that one of the purposes of the OCSPA "is to make private enforcement … attractive to consumers who otherwise might not be able to afford or justify the cost of prosecuting an alleged CSPA violation, which, in turn, works to discourage CSPA violations in the first place via the threat of liability for damages and attorney fees."[33]

The court nevertheless rejected the plaintiff's argument that the "loser pays" clause was unconscionable.[34] Ohio common law requires proof of both procedural and substantive unconscionability to invalidate a contract provision.[35] It held that the plaintiff did not demonstrate procedural unconscionability — i.e., that there was no defect or disparity in the bargaining process prior to the parties executing the agreement.[36] The unconscionability claim failed on that ground alone. The court then explained in dicta that the plaintiff did not prove substantive unconscionability based upon financial hardship.[37] It discussed the applicable standard at length and explained that the plaintiffs offered scant evidence of financial hardship.[38]

There are a number of takeaways from these cases for both individual litigants and companies when "loser pays" or cost-shifting clauses are part of arbitration agreements. First, individual litigants tend to attack arbitration agreements in their entirety with little success. They may be better served by focusing on certain components of the agreement — e.g., the "loser pays," cost and fee-shifting provisions. Second, a substantive unconscionability claim must be supported by specific, detailed evidence. This is especially true where financial hardship is involved. Third, in some jurisdictions, like Ohio, an unconscionability claim requires proof of both procedural and substantive unconscionability. This is a heavy burden to meet. Fourth, individual litigants may consider whether the arbitration process adversely affects or limits their ability to vindicate statutory rights and remedies. If so, “loser pays” and cost-shifting clauses may be severed on public policy grounds.

Companies seeking to enforce “loser pays” or cost-shifting clauses may consider amending their arbitration agreements or adjusting their litigation strategy. First, when defending a claim of substantive unconscionability based upon financial hardship, test the individual litigant’s proof. Mere allegations of financial hardship, without specific and detailed evidence, seem likely to fail. Second, mandating arbitration under the AAA commercial rules may allow a litigant to succeed on an effective vindication claim if she asserts statutory rights and remedies. It is possible to eliminate this risk by drafting around the rules granting arbitrators discretion to reallocate arbitration costs and fees.

Third, companies would be well served to periodically reevaluate the choice of law provisions contained in their arbitration agreements. Individual litigants have developed arguments for severing “loser pays” and cost-shifting clauses that may be more successful in certain jurisdictions than others. Choosing the “right” law for the purposes of an arbitration agreement may mitigate the risk. Fourth, consider whether expressly stating that the arbitration agreement, despite having a “loser pays” or cost-shifting clause, does not limit or prohibit an individual from asserting statutory rights and remedies, and that such remedies shall supersede potentially offending “loser pays,” cost and fee-shifting clauses. Finally, if the objective is to compel arbitration (regardless who pays the fees and costs), evaluate whether stipulating to severance of those clauses is appropriate on a case-by-case basis. The last two considerations certainly require difficult legal and business decisions that would have systemic consequences.

In summary, although on the surface the law and legal standards that favor enforcing arbitration agreements are well settled, arguments designed to weaken them may be gaining ground.

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[1] Larsen v. Citibank FSB, --- F.3d ----, 2017 WL 4250074 (11th Cir., Sept. 26, 2017)

[2] Id. at *13

[3] Id. at *13, *15

[4] Larsen, 2017 WL 4250074 at *13

[5] Id. at *14; JAMS Policy on Consumer Arbitrations Pursuant to Pre-Dispute Clauses

Minimum Standards of Procedural Fairness – ¶ 7 (https://www.jamsadr.com/consumer-minimum-standards/)

[6] American Arbitration Association Commercial Rules, R-53 and R-54

[7] Larsen, 2017 WL 4250074 at*13, *15

[8] Id. at *14

[9] Id.

[10] Daniels v. Encana Oil & Gas (USA) Inc., 2007 WL 3263288, *6 (D. Colorado 2017); American Arbitration Association Commercial Rules, R-53 and R-54

[11] American Express Co. v. Italian Colors Restaurant, 133 S.Ct. 2304, 2310 (2013) (citing Mitsubishi Motors Corp. v. Soler Chrysler-Plymouth, Inc., 473 U.S. 614,628 (1985)

[12] Green Tree Financial Corp.,-Ala. v. Randolph, 531 U.S. 79, 90 (2000); cf. Nesbitt v. FCNH, Inc., 811 F.3d 371, 377-379 (10th Cir. 2016) (explaining that in Green Tree, the Supreme Court implied that the effective vindication doctrine can apply even in situations where parties agreed to arbitrate at the beginning of their relationship and holding that the plaintiff met her burden of demonstrating that "being at the mercy of an arbitrator" concerning the allocation of arbitration costs and fees did not provide the same protections as the Fair Labor Standards Act)

[13] Daniels, 2007 WL 3263288 at *4

[14] Id.

[15] Daniels, 2007 WL 3263288 at *6

[16] Id.

[17] Daniels, 2007 WL 3263288 at *6

[18] Id.

[19] Valerio Sanders v. JGWPT Holdings, LLC, 2017 WL 4281123 (N.D. Illinois, Sept. 27, 2017),

[20] Id. at *7

[21] Id.

[22] Id.

[23] Id.

[24] Valerio Sanders, 2017 WL 4281123 at *8

[25] Gaither v. Wall & Associates, LLC, 2017-Ohio-765 (2d Dist.)

[26] Gaither, 2017-Ohio-765, ¶ 48

[27] Id.

[28] Gaither, 2017-Ohio-765, ¶ 51 (quoting DeVito v. Autos Direct Online, Inc., 2015-Ohio-3336 at ¶ 38

(8th Dist.) (internal quotation marks omitted))

[29] Hedeen v. Autos Direct Online, Inc., 2014-Ohio-4200 at ¶¶ 44, 48 (8th Dist.)

[30] Hedeen, 2014-Ohio-4200 at ¶ 48

[31] Id.

[32] Gaither, 2017-Ohio-765 at ¶ 52

[33] Id.

[34] Gaither, 2017-Ohio-765, ¶¶ 25, 47

[35] Id. at ¶ 25

[36] Id. at ¶¶ 18-20, 25

[37] Id. at ¶¶ 31-32

[38] Id. at ¶¶ 25-47