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News & Types: Commercial, Competition & Trade Update

Court Strikes Down Bogus Arbitration Provision

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Practices: Commercial, Competition & Trade, Litigation

Courts generally bend over backwards to enforce a freely negotiated arbitration provision, especially between commercial parties. But a recent case from the 7th Circuit Court of Appeals in Chicago provided an exception in striking down an unusual arbitration provision between a usurious lender and some financially-distressed individuals. (Deborah Jackson, et. al. v. Payday Financial, LLC, et. al. 7th Circuit Court of Appeals, No. 12-2617, August 22, 2014)

Deborah Jackson, Linda Gonnella, and James Binkowski lived in Illinois and apparently ran into financial difficulties. In 2010 or 2011, each of them borrowed $2,525 from loan companies owned and controlled by Martin Webb. Each transaction was completed online through websites operated by the loan companies. One of the loan companies was Payday Financial, LLC but there were others. Some of the loans were assigned to CashCall, Inc., a California corporation. (In the decision, the court referred to Mr. Webb and his web of entities as the "Loan Entities.")

The financial terms of these loans were pretty severe. For a $2,525 loan, the borrowers would pay, over time, $8,392 at an annual interest rate of 139%. The borrowers paid on the loans but it was not clear if the borrowers ever defaulted on the loans.

Whether in default or not, the borrowers were not happy. They sued the Loan Entities in Illinois state court, later removed to federal court. The claim was based on violations of criminal and civil usury statutes and fraud and deceptive practices. The borrowers sought damages, restitution, costs, and an injunction preventing the Loan Entities from making additional loans to Illinois residents.

The district court dismissed the borrowers' claims based on improper venue. The loan agreements included an arbitration provision, but an unusual arbitration provision. The loan agreements were governed by the "Indian Commerce Clause of the Constitution of the United States of America and the laws of the Cheyenne River Sioux Tribe", located in South Dakota. Any disputes would be decided by arbitration as follows:

- Arbitration would be conducted by the Cheyenne River Sioux Tribal Nation.
- The arbitration would be conducted by an authorized representative in accordance with the Tribal Nation's consumer dispute rules.
- The authorized representative would either be a "Tribal Elder or a panel of three members of the Tribal Council."
- The Loan Entities would pay the filing fees and fees charged by the arbitrator.

- The borrower did not need to travel to the reservation to participate in the arbitration. The borrower could participate by telephone or video conference.
- Some of the agreements provided for exclusive jurisdiction of the Cheyenne River Sioux Tribe.

The district court found that that it did not have venue because of the arbitration provision. The borrowers appealed and the 7th Circuit Court of Appeals sent the case back to the district court for more facts. The appeals court wanted to know:

a) Can anyone find out what the Cheyenne River Sioux Tribal law actually says?

b) Does the Cheyenne River Sioux Tribe actually have an arbitration mechanism?

For the first question, the district court found the answer to be yes – the parties could secure a copy of the Tribal Law. But the answer to the second was a "resounding no." The tribal leadership has no experience in private arbitration. The district court believed that the arbitration provision was an attempt to escape state usury laws limiting interest rates in consumer loans. So the arbitration provision was a "sham."

The district court was helped in its analysis by a similar dispute being disputed in another U.S. district court in Florida. The U.S. district court in Florida could actually observe how the tribe would conduct an arbitration and found some disturbing facts, such as:

- The arbitrator selected was Robert Chasing Hawk, a tribal elder.
- The arbitrator was selected by Martin Webb, the owner and operator of the Loan Entities. Mr. Webb is a member of the tribe.
- Robert Chasing Hawk is the father of Shannon Chasing Hawk. Shannon worked for one of the companies run by Mr. Webb.
- Mr. Chasing Hawk is not an attorney and has not been admitted to practice law in any jurisdiction, including the tribal jurisdiction.
- Mr. Chasing Hawk has no experience as an arbitrator, but was selected only because he was a Tribal Elder.

The Florida district court found that there was no way Mr. Chasing Hawk could be considered a disinterested person to decide this type of claim in arbitration.

The district court in Illinois found that the arbitration mechanism was a sham. After making these findings, the case went back to the 7th Circuit Court of Appeals.

Judge Ripple, writing for the Court of Appeals, acknowledged the U.S. Supreme Court's "overarching principle" that arbitration is a matter of contract that parties were free to determine themselves. However, the court still voided the arbitration provision.

"The arbitration clause here is void not simply because of a strong possibility of arbitrator bias, but because it provides that a decision is to be made under a process that is a sham from stem to stern. . . . [T]he tribe has no rules for the conduct of the procedure." [emphasis in original]

But the Loan Entities argued that, apart from the arbitration provision, exclusive jurisdiction still resided with the tribal nation. But the court rejected this argument. The court distinguished the limited jurisdiction of tribal

courts, especially over non-Indians. Basically, any jurisdiction over non-Indians in a tribal court must be based on activities on tribal land and with tribal members within the reservation. In this case, the borrowers did not engage in any activities inside the reservation – they only applied for a loan using a website. So tribal sovereignty over tribal lands or activities on tribal lands were not implicated.

So the appeals court reversed the dismissal of the borrowers' lawsuit and sent the case back to the district court. The borrowers were not only relieved of the obligation to arbitrate their claim at the tribal reservation, they were even awarded their costs.

In spite of the result in this case, the principle still stands that arbitration provisions in agreements will, in almost every case, be enforced as negotiated. In fact, parties appealing the result of an arbitration could put themselves at greater risk. (See, e.g., "Effort to Reverse Arbitration Award Fails",) (For an interesting contrast, see a party's successful effort to overturn an arbitration award. ("The Arbitration From Hell",) But, as the case illustrates, courts will look closely at "sham" arbitrations that may deprive a party of substantive and procedural rights, particularly in consumer transactions. As the court found, providing arbitration in a fictional forum with no rules is an example of a sham arbitration.