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Policing Contracts for Unconscionability: Guidelines for International Arbitrators Subject to the Scrutiny of US Courts

By

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Policing Contracts for Unconscionability: Guidelines for International Arbitrators Subject to the Scrutiny of US Courts

by PAUL BENNETT MARROW

1. INTRODUCTION

This article is about what courts in the United States take into account when determining whether a term or agreement is unconscionable, i.e. unduly harsh, inflexible, grossly unfair or one-sided, and how these rules compare with those applied throughout the rest of the world. Familiarity with the subject is essential if an arbitrator's performance and award are subject to the scrutiny of a court in the United States.

Arbitrators familiar with civil law systems who have to rule on unconscionability need to understand that they possess a broad discretionary power that is unstructured and fluid. But there are some limits. Also readers from other common law countries need to appreciate how different the US approach is from their own. Finally, American arbitrators need to be mindful that, if called upon to apply the laws of virtually any jurisdiction outside the United States other than Australia and perhaps Canada, the US scheme for policing the validity of private contracts is not applicable.

In recent years in the United States the issue of who (a court or an arbitrator) decides whether a term or an entire contract is invalid as being grossly unfair has garnered a great deal of attention. A recent US Supreme Court decision¹ makes it clear that if a challenge is directed to the entirety of the contract, as opposed to just the arbitration clause, the arbitrator must make the decision. Therefore it is important for arbitrators to familiarise themselves with the US approach on how courts define and use the doctrine of unconscionable contracts.

In the United States, the freedom to contract without governmental intervention is highly prized and the doctrine of unconscionability has evolved with this tradition in mind. Unconscionability is about the limits placed on the behaviour of the parties at the time of the ripening of the contract, but is not intended to act as a damper on the basic freedom to contract. One New York state appellate court observed²:

“It should always be remembered in analyzing (such) cases . . . ‘absent some violation of law or transgression of a strong public policy, the parties to a contract are basically free to make whatever agreement they wish, no matter how unwise it might appear to a third party’ . . . The doctrine of unconscionability, with its emphasis on the contract-making process, is really an expression of, rather than an exception to, this principle. By focusing on the manner in which a contract is entered into and the status of the parties, the doctrine is designed to insure freedom of contract and not to negate it.”

Unconscionability is a stand-alone tool that courts use along with companion doctrines such as duress, fraud and mistake. Occasionally it is incorporated into statutory schemes where the policing of contracting behaviour is thought to be important.

The equitable doctrine of unconscionability is grounded in the English common law tradition,³ meaning that judges made up the details over time. The doctrine developed in large

¹ *Buckeye Check Cashing v Cardegna*, 126 S. Ct. 1204 (2006).

² *State v Wolowitz*, 96 A.D. 2d 47, 68 (2d Dept., 1983).

³ In *Earl of Chesterfield v Janssen*, 28 E.R. 82, 100 (Ch., 1750) Hardwicke proclaimed an equitable rule against enforcing unconscionable agreements: “It may be apparent from the

measure to protect young lords inheriting huge estates from being victimised by unscrupulous people preying on their lack of sophistication. But in later years, the doctrine fell away from the mainstream of English legal thought.

The doctrine has taken on unique characteristics in the United States. Here courts sitting in equity use the doctrine to police *all* contracts.⁴ State courts⁵ have come up with a two-step method for analysis. First, they try to determine if the clause or contract is tainted by “procedural unconscionability” and then they look for “substantive unconscionability.”

Most civil law systems have no statutes that speak to unconscionability as it is understood in the common law. Courts police contracts by close reference to civil codes and judges are afforded little latitude. What is and is not unfair and oppressive is defined by statute. In most civil law countries, standard form contracts are regulated by specific statutory provisions that identify unfair factual scenarios and in some cases even provide examples and lists of clauses deemed unenforceable.

2. THE US APPROACH—DECIDING WHO RULES, THE ARBITRATOR OR THE COURT

If the contract unequivocally specifies that the arbitrator can rule on any issue, including the validity of the arbitration clause itself, all American courts will respect the wishes of the parties. That is because the Federal Arbitration Act (FAA) requires all courts to respect the contractual right of parties to remove their dispute from the public judicial system. What constitutes an unequivocal statement is not entirely clear. However, if the contract states that “the arbitrator shall have the power to rule on the validity of the entire contract, including the arbitration clause,” the requirement has been met. Incorporating rules of an arbitration association that in turn permit the arbitrator to rule on the contract *and* the arbitration clause have been found by the majority of courts to be sufficient.⁶

What happens if a clause provides that “any claim, dispute or controversy” shall be resolved by the arbitrator? Is this specific enough to include a ruling on the validity of the

intrinsic nature and subject of the bargain itself; such as no man in his senses and not under a delusion would make on the one hand, and as no honest man would accept on the other; which are unequitable and unconscientious bargains, and of such even the common law has taken notice.” See E.L. Brown, “The Uncertainty of U.C.C. Section 2-302: Why Unconscionability Has Become a Relic” (2000) 105 Com. L. J. 287, 290 and discussion, Rick Bigwood, *Exploitative Contracts* (Oxford: Oxford University Press, 2003), 227–278; A.H. Angelo and E.P. Ettinger, “Unconscionable Contracts: A Comparative Study of the Approaches in England, France, Germany and the United States” (1992) 14 Loy L.A. Int’l & Comp L.J. 455.

⁴ Legislatures got into the act with the creation of § 2-302 of the Uniform Commercial Code (UCC) but notably this statutory scheme leaves the definition of unconscionability to the courts. § 2-302. Unconscionable Contract or Clause, provides:

- (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. (emphasis added).

The UCC has been adopted in every state but Louisiana, a civil law jurisdiction; R.L. Hersbergen, “Unconscionability: The Approach of the Louisiana Civil Code” (1983) 43 La. L. Rev. 1315.

⁵ Some states, e.g. New York, have other similar schemes; §235-c Real Property Law is an example.

⁶ e.g. *The Shaw Group v Triplefine Int’l Corp* and *Rodriguez v American Technologies*, 322 F.3d 115 (2nd Cir., 2003); *Rodriguez v American Technologies, Inc.*, 136 Cal. App. 4th 1110 (2006).

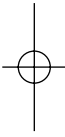


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arbitration clause? The answer appears to be that, if there is any question whatsoever, the court has authority to determine if the claim is against the arbitration clause or the contract itself. Where things go after that is a function of the court's ruling. In *Prima Paint Corp v Flood & Conklin Mfg Co.*⁷ the US Supreme Court held: "a federal court may consider only issues relating to the making and performance of the agreement to arbitrate." All other issues are for the arbitrator to resolve. This rule was recently reiterated by the Court in *Buckeye Check Cashing v Cardegna*.⁸ Moreover, the *Buckeye* court made it clear that for a court to intervene the challenge has to be "specifically" to the arbitration clause, implying that if the challenge is to the contract in its entirety and to the arbitration clause as well, the arbitrator rules on all the challenges. Therefore, if the laws of any state within the United States are to be considered, arbitrators need to be familiar with the rules governing unconscionability as they apply to the contract in the entirety and to an arbitration clause as well.

Taken together, if the agreement states categorically that the arbitrator has the power to rule on the validity of the contract and the arbitration clause, the contract governs. Similarly, if the challenge is directed to the contract as a whole and the arbitration clause as well, the arbitrator makes the determination. But if there is any ambiguity the courts decide issues involving the validity of the arbitration clause and the arbitrator decides the question of the validity of the entire contract. Let us look closely at what unconscionability is all about.


3. UNCONSCIONABILITY



It is often said that the doctrine of unconscionability is "an amorphous concept that evades definition."⁹ Professor Arthur Leff noted there is "nothing clear about the meaning of unconscionable except perhaps that it is pejorative"¹⁰ and that it is "easy to say nothing with words."¹¹ Still, there is no shortage of reported cases where judges have declared categorically that *they know it when they see it!* This may seem especially mystifying and challenging for those trained in the civil law tradition.

Whatever unconscionability is, it is rarely an issue where an agreement is commercial in nature and has been negotiated between two sophisticated parties of equal stature. The doctrine has gained traction in the review of transactions that include printed standard form agreements, "take-it-or-leave-it" contracts of adhesion. Not all adhesion contracts are unconscionable but all adhesion contracts containing clauses found to be unduly harsh, inflexible, grossly unfair and one-sided are.

The Dichotomy "Unconscionability" requires a judicial determination that a term or contract is, as a matter of law, unduly harsh, inflexible, grossly unfair and one-sided.¹² While there are many views about the propriety of specific clauses and contracts, all states have adopted the view that whether ruling in equity or applying and enforcing statutory schemes such as the UCC, the proper method of analysis is a search for "procedural" and "substantive" exploitation.¹³



⁷ 87 S. Ct. 1801 (1967).

⁸ 126 S. Ct. at 1210 "We reaffirm today that, regardless of whether the challenge is brought in federal or state court, a challenge to the validity of the contract as a whole, and not specifically to the arbitration clause, must go to the arbitrator".

⁹ *Wisconsin Auto Title Loans Inc v Jones*, 290 Wis. 2d 514 (2006).

¹⁰ "Unconscionability and the Code: the Emperor's New Clause" (1967) 115 U. Pa. L. Rev. 485, 487.

¹¹ Above fn.10, at 559.

¹² For a general discussion of the impact of subjectivity on judicial determinations about unconscionability, P.B. Marrow, "Squeezing Subjectivity from the Doctrine of Unconscionability" (2006) 53 Cleveland St. L. Rev. 187.

¹³ *Gillman v Chase Manhattan Bank*, below fn.25, at 10: "We address first the basic determination of the trial court on which its grant of relief is premised: that the security agreement was unconscionable when entered into and, therefore, unenforceable (see, UCC 2-302).

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Procedural unconscionability is about unfairness in the formation of the contract with the central concern being the likelihood of either an absence of meaningful choice or potential surprise. Did the term get into the contract because there was no other choice or was it intended to mislead? Factors to be considered include:

1. Is the contract standard form?
2. Is the suspect clause boilerplate?
3. Was the clause hidden or made non-conspicuous?
4. Is the language used incomprehensible to a lay person?
5. Was there gross inequality in bargaining power?
6. Was there exploitation of a weakness such as lack of sophistication or education?

Standard form agreements are problematic. Some courts hold that the presence of an adhesion agreement is sufficient to establish procedural unconscionability, although most require additional factors such as pressure tactics or interference with the ability of the other party to read the agreement before signing it.¹⁴

Greater sympathy exists where the complainant is a consumer. Merchants are presumed to be repeat participants in the marketplace and therefore to know how to protect their interests. However, in recent years, courts have come to recognise that smaller and less sophisticated merchants can also be preyed upon when dealing with enormous diversified corporate entities.¹⁵

Substantive unconscionability is about the operation of a suspect clause. The focus here is on the fairness and reasonableness of the provision at issue. The list of clauses with a potential to offend is long and always being added to. It includes clauses that impose:

1. significant price disparity;
2. private penalties;
3. a denial of a basic right or remedy;
4. liquidated damages;
5. disclaimers;
6. covenants not to compete;

An unconscionable contract has been defined as one which ‘is so grossly unreasonable or unconscionable in the light of the mores and business practices of the time and place as to be unenforceable according to its literal terms. (See 1 Corbin on Contracts, § 128, p. 400.) (*Mandel v Liebman*, 303 NY 88, 94.) The doctrine, which is rooted in equitable principles, is a flexible one and the concept of unconscionability is “intended to be sensitive to the realities and nuances of the bargaining process” (*Matter of State of New York v Avco Fin. Serv.*, 50 NY2d 383, 389–390). A determination of unconscionability generally requires a showing that the contract was both procedurally and substantively unconscionable when made—i.e., “some showing of an ‘absence of meaningful choice on the part of one of the parties together with contract terms which are unreasonably favorable to the other party’ (*Williams v Walker-Thomas Furniture Co.*, 350 F2d 445, 449).” (*Matter of State of New York v Avco Fin. Serv.*, supra, at 389; see also, *Jones v Star Credit Corp.*, 59 Misc 2d 189, 192.)” (emphasis added). This dichotomy was first suggested by Professor Arthur Leff in the cited article, describing procedural unconscionability as “bargaining naughtiness” and substantive unconscionability as “evils flowing from the contract”. For a sampling of cases adopting this view see *Maxwell v Fidelity Fin. Serv.*, 184 Ariz 82 (1995); *Hottle v BDO Seidman*, 268 Conn. 694 (2004); *All Am. Auto Savage v Camps Auto Wreckers*, 146 N.J. 15 (1996) and cases cited below fnn.14, 15, 17, 18 and 24.

¹⁴ Compare *Flores v Transamerica HomeFirst, Inc.*, 93 Cal. App. 4th 846 (2001) with *Morris v Redwood Empire Bancorp.*, 128 Cal. App. 4th 1305 (2005); *Morris v Snappy Car Rental*, 84 N.Y. 2d 21 (1994)

¹⁵ *A & M Produce Co. v FMC Corp.*, 186 Cal Rptr. 114 (Cal. Ct. App., 1982)



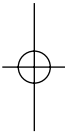
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7. limitations on remedies;
8. absence of mutuality concerning access to the judicial system;
9. pre-dispute mandatory arbitration.


There is some disagreement about the need for both types of unconscionability. While the majority of jurisdictions require both, many rely on a sliding scale as a guideline for magnitude of each. The stronger the substantive unconscionability component, the less the need for procedural unconscionability and vice versa.¹⁶

But can a term be voided upon showing just one type of unconscionability? This is not at all clear. In some states, New York being an example, where an operational term is found to be outrageous and oppressive, procedural unconscionability is not required.¹⁷ There the theory is that it does not matter how the term got into the contract; what matters is that it is highly offensive. Such cases are rare.

More problematic is the question: Is it possible for procedural unconscionability to be so oppressive that an otherwise conscionable term can be voided? The Illinois Supreme Court recently answered this question in the affirmative. *Razor v Hyundai Motor America*¹⁸ involved a term in a warranty that excluded incidental or consequential damages resulting from any inability to use a vehicle purchased from the agent of the defendant. The exclusion was not contained in the purchase agreement that was signed by the plaintiff and did not come to her attention until after she had completed the purchase. The reason was that the warranty was spelled out in the owner's manual delivered with the car, but it was located in the glove compartment. The Court observed¹⁹:



“Thus, on this record, we must conclude that the warranty information, including the disclaimer of consequential damages, was not made available to the plaintiff at or before the time she signed the purchase contract. . . . As previously noted, procedural unconscionability refers to a situation where a term is so difficult to find, read, or understand that the plaintiff cannot fairly be said to have been aware he was agreeing to it. Surely, whatever other context there might be in which a contractual provision would be found to be procedurally unconscionable, that label must apply to a situation such as the case at bar where plaintiff has testified that she never saw the clause nor is there any basis for concluding that plaintiff could have seen the clause, before entering into the sale contract. ‘[A] limitation of liability given to the buyer after he makes the contract is ineffective.’”



From this, the Court concluded that it would have been *unconscionable to enforce* the warranty.²⁰

A word of caution is in order. *Razor* may not be what it seems. Notwithstanding the *Razor* court's statement that procedural unconscionability, if severe enough, will

¹⁶ “In determining the conscionability of a contract, no set weight is to be given any one factor; each case must be decided on its own facts However, in general, it can be said that procedural and substantive unconscionability operate on a “sliding scale”; the more questionable the meaningfulness of choice, the less imbalance in a contract's terms should be tolerated and vice versa (Eddy, On the “Essential” Purposes of Limited Remedies; The Metaphysics of UCC Section 2-719[2], 65 Cal. L. Rev. 28, 41–42, n.56). While there may be extreme cases where a contractual term is so outrageous and oppressive as to warrant a finding of unconscionability irrespective of the contract formation process . . . such cases are the exception.” *State v Wolowitz*, above fn.2, at 68.

¹⁷ *Jones v Star Credit*, 59 misc. 2d 189 (1969).

¹⁸ 222 Ill. 2d 75 (2006). Compare *Wisconsin Auto Title Loans Inc v Jones*, above fn.13, at 59 “Even if the arbitration provision is procedurally unconscionable, it may be enforced if it is not substantively unconscionable”.

¹⁹ Above fn.18, at 101–102

²⁰ Above fn.18, at 105.

suffice, both types of unconscionability may have been present in this case. Exclusions of consequential damages, similar to the exclusion in *Razor*, have been found to be substantively unconscionable on the ground that the exclusion is an unreasonable reallocation of risk.²¹ The *Razor* court never addressed the substantive issue per se, but there seems little question that the allocation of risk must have been of concern or there would be no reason for the attention to the details of why the purchaser was unaware of the exclusion when she signed the purchase agreement. In other words, in the circumstances of this case, neither procedural nor substantive unconscionability could be found without the common denominator of an unreasonable reallocation of risk coupled with the inability of the purchaser to negotiate the allocation of the risk.

4. ARBITRATION CLAUSES: A UNIQUE ISSUE

To begin with, it may seem strange to some that the issue even exists. In many jurisdictions around the world, pre-dispute arbitration agreements in consumer agreements are void unless they are actually negotiated.²² But in the United States these agreements are commonplace and fully enforceable unless found to be unconscionable. As a result, an extensive body of case law has emerged addressing the issue of unconscionability.

The issue of whether or not an arbitration clause in a standard form agreement is per se procedurally unconscionable serves as a good example of the complexities that arbitrators may be called upon to deal with. A pre-dispute mandatory arbitration clause embedded in an adhesion agreement probably does not evidence procedural unconscionability where there is no evidence of something more.²³ Still, some courts have found that, where the clause is embedded in a standard form agreement, that is enough to meet the requirement of surprise coupled with an absence of meaningful choice.²⁴ How deeply embedded the clause has to be is not clear and the conclusion itself appears to conflict with the time-honoured rule that it is gross negligence not to read what you sign.²⁵ But this willingness by some courts seems to imply that it does not take much to find procedural unconscionability if the circumstances require. The issue is resolved in favour of there being no procedural unconscionability if the party drafting the agreement provides the signatory with the option to opt out.

Substantive unconscionability is about terms that operate in an unfair or unreasonable fashion. Within the context of mandatory arbitration, a group of factual situations have emerged raising questions about fairness and reasonableness:

1. Clauses that permit one party to select the arbitrator or specify qualifications.
2. Clauses that specify inconvenient locations for the arbitration proceedings.
3. Clauses that unnecessarily require one party or the other to incur burdensome expenses in the pursuit of a claim in arbitration.

²¹ e.g. *A&M Produce v FMC Corporation*, above fn.15.

²² Consider the Annex provision 1 (q): “TERMS REFERRED TO IN ARTICLE 3 (3) 1. Terms which have the object or effect of: 1(q) excluding or hindering the consumer’s right to take legal action or exercise any other legal remedy, particularly by requiring the consumer to take disputes exclusively to arbitration not covered by legal provisions, unduly restricting the evidence available to him or imposing on him a burden of proof which, according to the applicable law, should lie with another party to the contract”.

²³ In New Jersey the state Supreme Court has developed a four-factor test: (1) the subject matter of the contract; (2) the parties’ relative bargaining positions; (3) the degree of economic compulsion motivating the “adhering” party; and (4) the public’s interest affected by the contract, *Delta Funding Corporation v Alberta Harris*, 2006 N.J. Lexis 1155 (2006).

²⁴ e.g. *Flores v Transamerica HomeFirst, Inc*, above fn.14, and *Armendartz v Found Health Psychare, Inc*, 24 Cal. 4th 83 (2000).

²⁵ *Pimpinello v Swift & Co*, 253 N.Y. 159 (1930); *Gillman v Chase Manhattan Bank*, 73 N.Y. 2d 1 (1988); *Ortiz v Gomez*, 11 misc. 2d 1076A (2006).

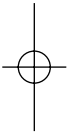


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4. Clauses that give the drafter the right to unilaterally alter the terms for arbitration.
5. Clauses that alter existing rights and remedies, examples being clauses that shorten a statute of limitations period or restrict the authority of arbitrators to impose punitive damages otherwise permissible by law.
6. Clauses that restrict class actions.
7. Clauses that lack mutuality, i.e. relegate one party to arbitration and give the other flexibility to pick and choose between arbitration and access to the judicial system.

Just because a clause appears on this list does not mean it is per se unconscionable. Determinations are made case by case and the courts have developed many special rules for confirming when a clause is offensive. For example, a claim that an arbitration clause could impose burdensome costs and expenses is not enough to establish substantive unconscionability. It must be shown that such is actually the case.²⁶ This in turn raises the question of whether or not justification can be shown for the requirements of a clause.


5. OTHER MATTERS



In Australia, the party facing a claim of unconscionability has the absolute right to show that given the circumstances it is reasonable for the term to be included in the agreement.²⁷ While there is no absolute right in the United States, in recent years the academic community has begun to focus on the possibility, with the conclusion that even unfair arbitration clauses are not always unconscionable if it can be shown that they serve a valid business purpose. For example, credit-card issuers include these clauses in almost all user agreements. This is not done to gain some special advantage or to be predatory but because they need flexibility and speed in the event of a default by the card user. Credit-card issuers operate in a very competitive environment and deal with customers about whom they have little current information. Their risk is significant. Arbitration provides card issuers with a tool to minimise risk if they uncover information suggesting that a user is or has become opportunistic. For card issuers, litigation means the credit-card user has an advantage because delay is inevitable. Rather than become bogged down by the judicial system, credit-card issuers are forced to accept settlement, making arbitration an attractive alternative.²⁸

Absent from the entire discussion about unconscionability in the United States is good faith. There, good faith comes into play in connection with the performance and enforcement of the contract, not its negotiation and contract formation. The UCC § 1-203 provides that “every contract or duty . . . imposes an obligation of good faith *in its performance and enforcement*,” while § 2-302 mandates that a contract becomes unconscionable when it is made, not when it is performed. There is no affirmative obligation to negotiate in good faith while there is an obligation to refrain from intentional conduct designed to exploit.

Finally, unconscionability in the United States has a time line. Determinations are made as at the time the agreement is made and no consideration is supposed to be given to subsequent events. For example, a party claiming unconscionability cannot rely on financial circumstances which have changed since the agreement was entered into.²⁹



²⁶ *Garrett v Hooter-Toledo*, 295 F. Supp. 2d 774 (N.D. Ohio, 2003).

²⁷ M. Sneddon, “Unconscionability in Australian Law: Development and Policy Issues” (1992) 14 *Loy. L.A. Int’l & Comp. L.J.* 545, 547.

²⁸ P.B. Marrow, “Non-Negotiable Mandatory Arbitration Clauses: From the Perspective of the Drafting Party” (2006) 24 *Alternatives* 164; C.R. Drahozal, “‘Unfair’ Arbitration Clauses” (2001) *U. Ill L. Rev.* 695.

²⁹ *Overstreet v Contigroup Cos.*, 462 F. 3d 409 (5th Cir., 2006); *American Software Inc v Ali*, 46 Cal. App. 4th 1386 (1996).

6. THE CONSEQUENCES OF AN ARBITRATOR'S ERROR

Assuming that an arbitrator makes a legal error and/or applies the wrong legal standard in determining whether a contract is unduly harsh, inflexible, grossly unfair and one-sided, will this open the award to *vacatur* pursuant to 9 U.S.C. § 10 (a)(4)³⁰ or applicable state law? The federal courts are consistent in holding that mere error, if made in good faith, is not grounds for *vacatur*.³¹ And a mere good faith error will not be subject to challenge on the grounds that the error is a manifest disregard of the law, this standard requiring that the arbitrator both clearly knew of the law in question and made a conscious effort to disregard it.³² These rules, taken together, suggest that if an arbitrator, in good faith, applies the wrong legal standard, the award will survive an attempt at *vacatur*. Most state courts follow this rule in the absence of a state statute mandating arbitration.³³

7. OTHER JURISDICTIONS

England is where the doctrine got its start. Originally it was designed to protect the wealthy from harsh and unfair contracts usually designed to separate them from their landed estates. Over time the doctrine has been found to be of limited use, probably because of reluctance to interfere with the freedom to contract. The modern approach has been to apply the doctrine in a very limited manner, in circumstances of exceptional oppression.³⁴

³⁰ “(a) In any of the following cases the United States court in and for the district wherein the award was made may make an order vacating the award upon the application of any party to the arbitration— . . . 4) where the arbitrators exceeded their powers, or so imperfectly executed them that a mutual, final, and definite award upon the subject matter submitted was not made”.

³¹ e.g. *Kyocera Corp v Prudential-Bache T Servs.*, 314 F.3d 987, 1003 (2003): “The risk that arbitrators may construe the governing law imperfectly in the course of delivering a decision that attempts in good faith to interpret the relevant law, or may make errors with respect to the evidence on which they base their rulings, is a risk that every party to arbitration assumes, and such legal and factual errors lie far outside the category of conduct embraced by § 10(a)(4)”.

³² “An arbitration award may be vacated if it exhibits a ‘manifest disregard of the law.’ *DiRussa v Dean Witter Reynolds, Inc.*, 121 F.3d 818, 821 (2d Cir., 1997). Given the deference afforded arbitration decisions, this standard requires more than a mistake of law or a clear error in fact finding. *Siegel v Titan Indus. Corp.*, 779 F.2d 891, 892-93 (2d Cir., 1985). Manifest disregard can be established only where a governing legal principle is ‘well defined, explicit, and clearly applicable to the case,’ and where the arbitrator ignored it after it was brought to the arbitrator’s attention in a way that assured that the arbitrator knew its controlling nature. *New York Tel. Co v Communications Workers of America Local 1100, AFL-CIO District One*, 256 F.3d 89, 91 (2d Cir., 2001) citing *Halligan*, 148 F.3d at 202; see also *DiRussa*, 121 F.3d at 823 (holding that arbitrators are only charged with having knowledge of governing law identified by the parties). An arbitrator (even an arbitrator who is a lawyer) is often selected for expertise in the commercial aspect of the dispute or for trustworthiness, rather than for knowledge of the applicable law, and under the test of manifest disregard is ordinarily assumed to be a blank slate unless educated in the law by the parties.”

Goldman v Architectural Iron Co., 306 F. 3d 1214, 1216 (2d Cir., 2002); *First Options of Chicago, Inc v Kaplan*, 514 U.S. 938, 942-43 (1995).

³³ Compare *Tilbury Fabrics v Stillwater, Inc.*, 56 N.Y. 2d 624 (1982); *Motor Vehicle Accident Indemnification Corp v Aetna Cas. & Sur. Co.*, 89 N.Y. 2d 214 (1996); *Detroit Automobile Inter-Insurance Exchange v Standfest*, 416 Mich. 407 (1982).

³⁴ e.g. *Alec Lobb (Garages) Ltd v Total Oil (Great Britain) Ltd* [1985] 1 W.L.R. 173 at 183 (CA); *Lloyds Bank Ltd v Bundy* [1975] 1 Q.B. 326 (CA); *A Schroeder Music Publishing Co v Macaulay* [1974] 1 W.L.R. 1308 (HL); *Credit Lyonnais Bank Nederland NV v Burch* [1997] 1 All E.R. 144.

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In Canada, unconscionability is defined as the taking of undue advantage of an inequality in bargaining power.³⁵ In Australia, two elements are required, one party being at a special disadvantage and the other unfairly benefiting by the special disadvantage. Where both conditions are present, the courts will set aside transactions but not before giving the stronger or advantaged party an opportunity to show that the transaction was fair, just and reasonable in the circumstances.³⁶

All modern civil law systems have tools for policing contracts. This is usually accomplished by requiring judges to use the dictates of civil codes as the boundary for discretion. Judge-made doctrines are uncommon but possible. One example is France, where the doctrine of pre-contractual good faith has been established by the courts.³⁷ France also has *lésion*, a doctrine meaning “a loss that results from a serious imbalance or disproportion in the reciprocal obligations of parties to a contract.”³⁸ This is sometimes used with the general articles of the French Civil Code to police agreements.³⁹ But in most of these systems unconscionability is not seen as a stand-alone tool available to courts. Some countries, such as Germany (e.g. Art.138(2) of the Civil Code) and Switzerland (e.g. Art.242 of the Civil Code), have adopted legislation that identifies specific factual scenarios as being unfair and unenforceable. In Italy, as a technical matter, the legal system does not recognise unconscionability as it is known in the common law; but Council Directive 93/13 adopted Arts 1341 and 1342, schemes directed to standard form consumer agreements that provide lists of oppressive clauses.⁴⁰

Inherent in the civil law approach is the doctrine of good faith. While the principle of good faith exists in the common law, it has its limitations. For example, in the common law tradition there is no duty to negotiate in good faith on the theory that the option to walk away from a bad deal is always available. But most civil law systems do impose such a duty. The broad reach of this duty may well reflect local political and historical concerns. Consider as examples India and China. In India, where English law came into conflict with Hindu and Mohammedan law, policing is accomplished within the context of free consent and undue influence as these principles are defined and brought into play by a series of statutes.⁴¹ In China, where communist and capitalist values have had to be reconciled, the Uniform Contract Law (1999) (UCL) places great emphasis on good faith. Good faith is defined as honesty and trustworthiness.⁴² The UCL also imposes the duty to act in a fair manner and the draftsman of a standard form agreement has a duty to disclose harsh terms. Certain types of exculpatory clauses are deemed invalid.⁴³

³⁵ *Hunter Engineering Inc v Syncrude Canada Ltd*, 57 D.L.R. 4th 321 (1989); S.M. Waddams, “Unconscionability in Canadian Contract Law” (1992) 14 Loy. L.A. Int’l & Comp. L.J. 541.

³⁶ Sneddon, “Unconscionability in Australian Law”, above fn.27.

³⁷ M.W. Hesselink, “The Concept of Good Faith,” Molengrafica Series, (2003) *International Contract Law* 103.

³⁸ Angelo and Ettinger, “Unconscionable Contracts”, above fn.3, 474.

³⁹ Arts 1118, 1674 and 1685. Another example is Art.2078. It prohibits someone holding property as a pledge appropriating that property *ipso facto*, Angelo and Ettinger, “Unconscionable Contracts”, above fn.3, 473–478

⁴⁰ C.Cicoria, “The Protection of the Weak Contractual Party in Italy vs. United States Doctrine of Unconscionability,” (2003) 3 *Global Jurist*, article 2 available at www.bepress.com.

⁴¹ Indian Contract Act 1872 ss.14, 16 and 19A; Specific Relief Act 1963 s.20; Evidence Act 1872 s.111; M.L. Sarin, “Contract Unconscionability in India” (1992) 14 Loy. L.A. Int’l & Comp. L. J. 569.

⁴² W. Liming and X. Chuanxi, “Fundamental Principles of China’s Contract Law” (1999) 13 *Colum. J. Asian L.* 1, 16: “The principle of good faith (*chengxin*; literally, honesty and trustworthiness) requires parties to a civil act to conduct themselves honorably, to perform their duties in a responsible manner, to avoid abusing their rights, to follow the law and common business practice, and so on”. J. Matheson, “Convergence, Culture and Contract Law in China” (2006) 15 *Minn. J. Int’l L.* 329.

⁴³ Arts 39 and 54.

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The Islamic world presents a completely different perspective on the problem of unfair agreements. The Western concepts of freedom to contract and good faith exist in all Islamic countries because they are recognised by the Qur'an. But these principles are trumped by the overriding belief that a contract is divine in nature. This imposes a duty to perform the contract unless its terms are otherwise in violation of *Shari'a* because of dictates of the Qur'an. Strict constructionists in countries such as Saudi Arabia reject the Western doctrine of efficient breach.⁴⁴

With respect to standard form consumer contracts, the European Union has adopted an approach similar to the German and Swiss preference for defined fact patterns and clauses with the enactment of Council Directive 93/13 (1993), "On Unfair Terms in Consumer Contracts." Article 3 provides:

1. A contractual term which has not been individually negotiated shall be regarded as unfair if, contrary to the requirement of good faith, it causes a significant imbalance in the parties' rights and obligations arising under the contract, to the detriment of the consumer.
2. A term shall always be regarded as not individually negotiated where it has been drafted in advance and the consumer has therefore not been able to influence the substance of the term, particularly in the context of a pre-formulated standard contract.
The fact that certain aspects of a term or one specific term have been individually negotiated shall not exclude the application of this Article to the rest of a contract if an overall assessment of the contract indicates that it is nevertheless a pre-formulated standard contract.
Where any seller or supplier claims that a standard term has been individually negotiated, the burden of proof in this respect shall be incumbent on him.
3. The Annex shall contain an indicative and non-exhaustive list of the terms which may be regarded as unfair.

The Annex leaves little room for judicial interpretation as to the fairness of clauses listed therein. Included in this group are clauses that:

1. Limit the liability of a seller for the death or for personal injury resulting from the seller's omission or act.
2. Inappropriately limit the right of a consumer in the event of the seller's non-performance or inadequate performance.
3. Make the terms of the agreement binding on the purchaser but leave the seller's obligations subject to the discretion and control of the seller.
4. Bind a consumer to terms and conditions that the consumer did not have a meaningful opportunity to review prior to a purchase.
5. Allow the seller to unilaterally alter or modify terms without a valid reason set forth in the agreement.

Other modern legal systems have statutory schemes for the regulation of standard form agreements and virtually all of them are rooted in the civil law concept of good faith. For example: Japan, the Consumer Contract Act (2001); the Indian Consumer Act 1986; Adhesion Contracts Act of South Korea; Brazilian Consumer Protection Act 1990. This includes England,⁴⁵ where good faith is not given the same emphasis with respect to the general rules of contracting. In Australia, a statute specifically addresses unconscionable

⁴⁴ F. Kutty, "The *Shari'a* Factor in International Arbitration" (2006) 28 Loy. L.A. Int'l Comp L. Rev. 565, 609-610.

⁴⁵ The Unfair Terms Act 1977, Consumer Credit Act 1974 and Money-Lenders Act 1990.

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contracts without direct reference to good faith and provides a list of factors to be considered. The same statute incorporates by reference the equitable principles developed by the courts.⁴⁶

Finally, the UNIDROIT Principles of International Commercial Contracts (2004) presents a blending and harmonising of common and civil law approaches to the issues involved. Policing of unfairness as applicable to procedural issues involving contract formation is governed by Art.2. Standard forms and standard terms are defined as those which “are prepared in advance” by one party and “actually used without negotiation with the other party.”⁴⁷ While tolerated, these forms and terms are subject not only to all rules for contract formation⁴⁸ but to three significant additional restraints:

No term contained in standard terms which is of such a character that the other party could not reasonably have expected it, is effective unless it has been expressly accepted by that party. In determining whether a term is of such a character regard shall be had to its content, language and presentation.⁴⁹ In case of conflict between a standard term and a term which is not a standard term the latter prevails.⁵⁰

Where both parties use standard terms and reach agreement except on those terms, a contract is concluded on the basis of the agreed terms and of any standard terms which are common in substance unless one party clearly indicates in advance, or later and without undue delay informs the other party, that it does not intend to be bound by such a contract.⁵¹

Principles involving bargaining behaviour apply to all contracts regardless of form. Thus, fraud,⁵² threat⁵³ and mistake⁵⁴ can be invoked to challenge any agreement. But most important, the Principles police for clauses that are “grossly unfair” and that contain a term that unjustifiably gives one party excessive advantage. This gross disparity comes about by exploitation of a bargaining handicap defined as:

“dependence, economic duress or urgent needs . . . improvidence, ignorance, inexperience or lack of bargaining skill . . . and the nature and purpose of the contract.”⁵⁵

Hopefully, this short overview should make it apparent that there are many approaches to defining unfair behaviour, unfair contract terms and even unconscionability. Arbitrators called on to apply the laws of a system that differs from their own must be mindful to look openly and beyond their own traditions.

8. CONCLUSION

What is meant by an “unfair” agreement is in large measure a function of geographic location, culture and training. While there are no hard and fast rules as to exactly what is unfair, many legal cultures tie the conclusion to attitudes about reciprocal obligations concerning good faith and honesty. In most legal systems the role of equity is down played and the flexibility that equity affords might seem perplexing and perhaps even daunting.

⁴⁶ Trade Practices Act 1974 ss.51AA and 51AB; R. Bigwood, “*Australian Competition and Consumer Commission v CG Berbatis Holdings Pty Ltd: Curbing Unconscionability: Berbatis and the High Court of Australia*” (2004) 28 Melbourne U. L.R. 203.

⁴⁷ Art.2.1.19 (2).

⁴⁸ Art.2.1.19 (1); M.J. Bonell, *An International Restatement of Contract Law*, 3rd edn (Washington D.C.: Bridge Street Books, 2005), pp.151–158.

⁴⁹ Art.2.1.20.

⁵⁰ Art.2.1.21.

⁵¹ Art.2.1.22.

⁵² Art.3.8.

⁵³ Art.3.9.

⁵⁴ Arts 3.4 and 3.5.

⁵⁵ Art.3.10.

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Arbitrators called upon to evaluate contracts and contract terms by application of the laws of the United States may find that doing so is challenging and unfamiliar. But complying with any such mandate will be made easier if before proceeding they see to it that they have been briefed thoroughly by the parties on their views concerning applicable law and local attitudes on the issue of unconscionability. Developing a checklist will simplify matters and reduce the likelihood of a subsequent challenge based on doctrines such as “manifest disregard” for law and those enumerated in Art.5 of the New York Convention. The checklist of concerns should include whether the law of the jurisdiction involved requires a showing of both procedural and substantive unconscionability and the magnitude of each where both must be shown, whether or not there are special rules for evaluating arbitration clauses, and facts confirming the time frame of the materialisation of the unconscionability. And, most important, arbitrators must take special care to factor out preconceived attitudes, imposed by the legal culture from which they come, concerning pre-contract good faith obligations.