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# CONSUMER & PERSONAL RIGHTS Litigation

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## A Brief "Primer" For Young Lawyers On California's Unfair Competition Laws

by Christopher Chorba\*

Every state has adopted a local version of Section 5 of the Federal Trade Commission Act (15 U.S.C. § 45(a)), which proscribes unfair methods of competition and deceptive or misleading practices. Commonly referred to as "Little FTC Acts," these statutes take many forms, but they have in common a core set of standards forbidding "unfair" or "deceptive" practices, as well as provisions for governmental and private enforcement of the acts. California's Little FTC Acts are codified in California Business & Professions Code sections 17200 through 17208 ("Section 17200") and sections 17500 through 17535 ("Section 17500"), as well as California Civil Code sections 1750 *et seq.* ("Consumers Legal Remedies Act").

California's law is important not only for its broad statutory language (notwithstanding recent amendments), but also because the state serves as the forum of choice for nearly half the country's class action litigation, and for all "quasi-class" action litigation.

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## The Evolving Definition of the "Unfair" in California's Unfair Competition Law

by Daniel K. Slaughter\*

California's Unfair Competition Law, Cal. Bus. & Prof. Code §§ 17200 *et seq.* ("UCL"), is widely regarded as one of the broadest consumer protection laws in the country. It allows for lawsuits challenging "unlawful," "deceptive" or "unfair" acts or practices. The first two of these are fairly well circumscribed. The meaning of "unlawful" is grounded in the statutory and common law of California, and "deceptive," although not the same as common law fraudulent, borrows from the body of law addressing that standard tort. But how do we decide what is "unfair"?

Proponents of an expansive interpretation of unfairness believe that the statute is intended to cover a wide range of "improper" practices and should not be limited by a bright-line standard that can be applied to all cases. They are concerned that the standard be broad enough to allow the courts to address allegations of unscrupulous behaviour in a wide variety of situations.

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### COMMITTEE CO-CHAIRS

**Lois C. Greisman**  
Federal Trade Commission  
(202) 326-3404  
lgreisman@ftc.gov

**Andrew L. Sandler**  
Skadden, Arps, Slate, Meagher & Flom LLP  
(202) 371-7400  
asandler@skadden.com

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**James Zibarras**  
Borden Ladner Gervais LLP  
(416) 367-6238  
jzibarras@blgcanada.com

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(213) 229-7396  
cchorba@gibsondunn.com

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(415) 772-6058  
russell.cohen@hellerehrman.com

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(416) 367-6259  
imassimi@blgcanada.com

**Robert C. Sohns**  
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rsohns@lonestarlegal.org

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## Message from the Co-Chairs

Welcome back from what we hope has been an enjoyable summer. We want to update you on our ambitious new plans for the Consumer & Personal Rights Litigation Committee. We hope to make the Committee an important resource on enforcement and litigation developments of interest to lawyers litigating on behalf of and/or counseling companies and individuals with respect to consumer rights in commercial relationships. Our mission is to become a primary information resource and forum for discussion on developments relating to sales practices, product suitability, marketing and advertising as well as privacy and information security. While these issues have been most pronounced in the financial services sector with respect to lending and investment product offerings, similar issues have surfaced in telecommunications and computer sales, and virtually all other market sectors. In addition, privacy and information security continue to be a top priority and present significant challenges for many business sectors.

Recent key developments that the Committee will cover on its revamped website and newsletters and through programming at Litigation Section and Committee meetings and webcasts include class action developments related to The Class Action Fairness Act and recent judicial decisions on class settlement parameters, class certification and class discovery issues; and recent consumer protection and information security enforcement orders by the Federal Trade Commission, State Attorney Generals and other federal and state agencies.

Please join us as active participants in our efforts to grow and better serve Committee membership.

Lois C. Greisman, [lgreisman@ftc.gov](mailto:lgreisman@ftc.gov)  
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**A Brief Primer** (Continued from Page 1)

In general, this law prohibits “any unlawful, unfair or fraudulent business act or practice and unfair, deceptive, untrue or misleading advertising. . . .”

**I. “Unlawful” Prong**

The first substantive prong of this statute – “unlawful” acts or practices – includes anything that properly can be called a business practice or act that also is “forbidden by law.” *Farmers Ins. Exch. v. Superior Court*, 2 Cal. 4th 377, 400 (1992). Many courts have stated that a violation of any law (state, federal, and even municipal) will suffice as a predicate for violation of Section 17200, although the Supreme Court of California has not yet explicitly addressed a challenge to the use of this statute to enforce federal laws.

**II. “Unfair” Prong**

The law is not as clear with respect to “unfair” business acts or practices, the second substantive prong. The Supreme Court of California has held that in Section 17200 cases among competitors, “the word ‘unfair’ means conduct that threatens an incipient violation of an antitrust law, or violates the policy or spirit of one of those laws because its effects are comparable to or the same as a violation of the law, or otherwise significantly threatens or harms competition.” *See Cel-Tech Communications, Inc. v. Los Angeles Cellular Tel. Co.*, 20 Cal. 4th 163, 187 (1999). The Court sharply criticized the older formulations, or “purely subjective” definitions of “unfairness,” as “too amorphous and provid[ing] too little guidance to courts and businesses.” *Id.* at 184-85. The Court “sympathize[d]” with California businesses’ “need to know, to a reasonable certainty, what conduct California law prohibits and what it permits.” *Id.* at 185. Yet in the same breath, the Court expressly limited this definition to actions between competitors. *Id.* at 187 n.12.

The intermediate appellate courts in California have applied several different tests of “unfairness” in consumer actions. *Compare Camacho v. Automobile Club of Southern California*, 139 Cal. App. 4th 63, 72, *rehearing granted*, 2006 Cal. App. LEXIS 919 (2006) (holding that the FTC’s test of unfairness applies) *with Scripps Clinic v. Superior Court*, 108 Cal. App. 4th 917, 940 (2003) (applying the *Cel-Tech* formulation in a consumer case) *and State Farm Fire & Casualty Co. v. Superior Court*, 45 Cal. App. 4th 1093, 1103-04 (1996) (“The test of whether a business practice is unfair ‘involves an examination of [that practice’s] impact on its alleged victim, balanced against the reasons, justifications and motives of the alleged wrongdoer. In brief, the court must weigh the utility of the defendant’s conduct

against the gravity of the harm to the alleged victim . . . .”). Other courts apply various iterations of this test while urging the Supreme Court to clarify which test should apply. *See generally Bardin v. DaimlerChrysler Corp.*, 136 Cal. App. 4th 1255, 1274 (2006).

**III. “Fraud” Prong**

“Fraudulent” business acts or practices have been described as those that are “likely to deceive” members of the public. *Committee on Children’s Television, Inc. v. General Foods Corp.*, 35 Cal. 3d 197, 211 (1983). In light of recent amendments to Section 17200, however, a new appellate decision held that actual reliance and injury are required to state a claim under this prong. *See Pfizer v. Superior Court*, No. B188106, 2006 Cal. App. LEXIS 1068, at \*25, \*29 (Cal. Ct. App. July 11, 2006) (noting that “the mere likelihood of harm to members of the public is no longer sufficient for standing to sue”). While prior decisions authorized claims by parties who did not actually read the advertising, this court held that the new law no longer allowed such claims. *Id.* at \*29.

**IV. Recent Statutory Amendments**

In November 2004, California voters approved a statewide ballot initiative that enacted significant amendments to Sections 17200 and 17500. Prior to these amendments, these laws were characterized by very liberal standing requirements. The language of the statute did not limit *who* could bring these actions, and plaintiffs did not need to satisfy the traditional standing requirement of actual injury in fact. As a result, Section 17200 was a frequent target of judicial criticism. *See, e.g., Stop Youth Addiction, Inc. v. Lucky Stores, Inc.*, 17 Cal. 4th 553, 584 (1998) (explaining that the statute was unique in the country in permitting relatively “unbridled standing” and failing to distinguish between “plaintiffs with genuine business disputes, ‘true’ private attorneys general, and those who use the Law as a means of leveraging settlements at the expense of the public interest.”) (Brown, J., dissenting).

Because of this “unbridled standing,” California was a magnet for consumer litigation, and this fueled the perceived hostile business climate in California. *See, e.g., Graham v. DaimlerChrysler Corp.*, 34 Cal. 4th 553, 602-03 (2005) (Chin, J., dissenting) (observing that in the current political climate, “Californians are increasingly concerned about extortionate lawsuits against businesses, large and small, and worried that the legal climate in California is so unfriendly to businesses that many are leaving the state and others are deterred from coming here in the first place”).

The lack of any real standing limitations led to frustration among many businesses, who were sued by individuals who had not used the product or service in question, viewed the advertising, or had any other actual contact with the defendant. Section 17203 now requires that private plaintiffs satisfy the standing requirements of Section 17204 and comply with traditional class action requirements. Cal. Bus. & Prof. Code § 17203. Section 17204 allows private plaintiffs to bring actions under this law if they have “suffered injury in fact and has lost money or property as a result of such unfair competition.” *Id.* § 17204. The voters approved similar modifications to Section 17500. *See* Cal. Bus. & Prof. Code § 17535 (requiring private plaintiffs to have “suffered injury in fact and has lost money or property as a result of a violation of this chapter”). Changes to both laws also required that any civil penalties be used “exclusively” by the California Attorney General “for the enforcement of consumer protection laws.” *Id.* § 17206; § 17536.

The Supreme Court of California recently decided that these amendments apply to actions filed prior to November 2004. *See Californians for Disability Rights v. Mervyn’s, LLC*, Case No. S131798, 2006 Cal. LEXIS 8774 (July 24, 2006). The Court explained that “[t]o apply Proposition 64’s standing provisions to the case before us is not to apply them ‘retroactively,’ as we have defined that term, because the measure does not change the legal consequences of past conduct by imposing new or different liabilities based on such conduct.” *Mervyn’s*, 2006 Cal. LEXIS 8774, at \*16. The Court also held that plaintiffs must satisfy standing at every stage of the proceeding, and Proposition 64 “withdraws the standing of persons who have not been harmed to represent those who have.” *Id.* at \*18. Finally, as an additional basis for its ruling, the Court explained that the plaintiff in *Mervyn’s* sought only injunctive relief, and a long line of precedent requires courts to apply the law as it exists at the time it enters the injunctive order and not as it was at the time of the filing of the lawsuit. *Id.* at \*20 n.5.

In a separate ruling, the Supreme Court considered whether private plaintiffs who do not satisfy the new requirements may substitute themselves out of a pending action in favor of a new plaintiff with standing. *See Branick v. Downey Savings & Loan Ass’n*, Case No. S132433, 2006 Cal. LEXIS 8775 (July 24, 2006). While rejecting certain “categorical” arguments against substitution offered by the defendant, the Court referred this issue to the trial court for resolution, because the plaintiff in *Branick* had not yet sought leave to substitute a new plaintiff. *See id.* at \*14, 16-17 (“Given the question’s potential factual and legal complexity, and without knowing the identity of the hypothetical new plaintiff or the

nature of the claims he or she might assert, for this court to attempt to decide at this stage of the proceedings whether any possible amendment would impermissibly change the nature of the action would be inappropriate.”).

## V. Relief Available Under Section 17200

Private plaintiffs who bring actions under Section 17200 and satisfy these standing limitations may obtain injunctive relief. Cal. Bus. & Prof. Code § 17203. In terms of a monetary recovery, the statutory scheme authorizes only such orders “as may be necessary to *restore* to any person in interest any money or property, . . . acquired by means of such unfair competition.” *Id.* As the Supreme Court of California has explained, the use of “restore” in the statute limits recoveries to restitution, or “the return of money or property that was once in [the plaintiff’s] possession” or that is withheld by defendant and in which the plaintiff has a vested “ownership interest.” *Korea Supply Co. v. Lockheed Martin Corp.*, 29 Cal. 4th 1134, 1150-51 (2003). The Court explained that “nonrestitutionary disgorgement is not an available remedy in an individual action under” Section 17200. *Korea Supply Co.*, 29 Cal. 4th at 1148-49. In short, a defendant can “restore” only “money or property that defendants took *directly* from plaintiff” or “money or property in which [plaintiff] has a vested interest.” *Id.* at 1146-47 (emphasis added). Several recent appellate decisions also rejected the “disgorgement” remedy left open in *Korea Supply*: disgorgement in certified class actions into a fluid recovery fund. *See, e.g., Madrid v. Perot Systems Corp.*, 130 Cal. App. 4th 440, 461 (2005) *Feitelberg v. Credit Suisse First Boston, LLC*, 134 Cal. App. 4th 997, 1016, 1020 (2005) (specifically rejecting “nonrestitutionary class-wide monetary relief” as “foreclosed by the rationale of *Korea Supply*”).

*\*Christopher Chorba, an associate in the Los Angeles office of Gibson, Dunn & Crutcher, is a member of the Firm’s Consumer Class Action Practice Group.*

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## The Evolving Definition (Continued from Page 1)

Those who seek to narrow the meaning of “unfair” argue that broad, vague standards are too subjective, leaving them and the trial courts with no guidelines as to how to distinguish between proper and improper behaviour.

This article reviews the state of the law on this issue, starting with *Cel-Tech Communications, Inc. v. Los Angeles Cellular Telephone Co.*,<sup>1</sup> the California Supreme Court’s most recent attempt to address the issue, and subsequent federal trial court and California Court of Appeal decisions. Although the post *Cel-Tech* cases are not uniform in their treatment of “unfairness,” when read together the current case law does indicate an approaching consensus on what is and what is not “unfair.”<sup>2</sup>

### I. The “Old” Standards and Cel-Tech

#### i. Times Mirror and Casa Blanca – The Old Standards

Before *Cel-Tech*, California courts used two different standards in examining “unfair” cases, referred to as the *Times Mirror* and *Casa Blanca* standards. These standards reflected a desire to interpret the statute in a flexible manner, enabling it to sweep into its ambit a broad range of acts.

But because evaluating “unfairness” under these standards was done through subjective tests and vague articulations, seemingly any lawsuit alleging “unfairness” escaped initial pleading challenges, and often was also immune to summary judgment. Indeed, the standards did not even give judges much guidance at a trial, encouraging an “I know it when I see it” approach to decisions in these cases. Some litigants also complained that the inability to reach an early resolution through motion practice emboldened plaintiffs to file “strike suits” relating to practices that no one would actually find objectionable.

The first “old” standard of “unfairness” establishes a balancing test weighing the utility of the defendant’s conduct against the harm to the plaintiff. This test was first articulated in *Motors Inc. v. Times Mirror Co.* (“*Times Mirror*”),<sup>3</sup> a class action against the defendant newspaper publishing company, claiming, inter alia, that the defendant’s two-tiered advertising rate structure was “unfair” under 17200 because it charged retailers 30% less than it charged manufacturers, wholesalers and distributors. In holding that the case should not be dismissed at the pleading stage, the Court of Appeal provided this definition of “unfair”:

... the determination of whether a particular business practice is unfair necessarily involves an examination of its impact on its alleged victim, balanced against the reasons, justifications and motives of the alleged wrongdoer. In brief, the court must weigh the utility of the defendant’s conduct against the gravity of the harm to the alleged victim—a weighing process quite similar to the one enjoined on us by the law of nuisance.<sup>4</sup>

*Times Mirror* also implied that an unfairness determination could not be made on the pleadings. “While this [balancing] process is complicated enough after a hearing in which the defendant has revealed the factors determining the utility of his conduct, it is really quite impossible if only the plaintiff has been heard from, as is the case when it is sought to decide the issue of unfairness on demurrer.”<sup>5</sup>

The second “old” standard is two-pronged, holding that a practice is unfair if it offends an established public policy or is immoral, unethical, oppressive, unscrupulous or substantially injurious to consumers. This standard was first articulated in *People v. Casa Blanca Convalescent Homes, Inc.* (“*Casa Blanca*”),<sup>6</sup> a case involving allegations that the defendant convalescent home had provided inadequate care to residents of the home. The Court of Appeal discussed “unfairness” by looking to Federal Trade Commission guidelines sanctioned by the United States Supreme Court in *F.T.C. v. Sperry & Hutchinson Co.*<sup>7</sup> It then concluded that “an ‘unfair’ business practice occurs when it offends an established public policy or when the practice is immoral, unethical, oppressive, unscrupulous or substantially injurious to consumers.”<sup>8</sup>

These two standards subsequently began to be used extensively by the California trial courts, and made it virtually impossible to prevent a 17200 “unfairness” lawsuit from continuing past demurrer and summary judgment. *Times Mirror* required a balancing that could not be accomplished at the pleading stage, and *Casa Blanca* prevented summary judgment because there would nearly always be a fact question as to whether the act was sufficiently “immoral, unethical, oppressive, unscrupulous or substantially injurious.” Thus, pre *Cel-Tech*, filing an “unfair” claim seemingly guaranteed a trial, or a settlement before trial. Of course, settled cases were not appealed, limiting the opportunities of the appellate courts to further refine the standards and appropriately limit the definition of “unfair.”

## ii. Cel-Tech

All of this began to change in 1999, when the California Supreme Court issued its decision in *Cel-Tech Communications, Inc. v. Los Angeles Cellular Telephone Co.*<sup>9</sup> The case was brought by a group of cellular phone handheld sellers against a competing seller, who was also one of two federally licensed providers of cell phone service. The plaintiffs claimed that the defendant was cutting its handheld prices to a profit-losing level, in an effort to bring in customers who would then pay for service from the defendant. Because the plaintiffs had no license to sell service, the handheld price-cutting option was unavailable to them. Plaintiffs claimed that they were “unfairly” priced out of the handheld retail market. The Supreme Court reversed the trial court’s dismissal of the case, and remanded with a new “unfairness” test to apply.

*Cel-Tech* affirmed that the UCL was purposely broad, so as to capture a wide range of “unfair” activities beyond the *ex ante* ken of legislators. However, the *Cel-Tech* court insisted that “[a]lthough the unfair competition law’s scope is sweeping, it is not unlimited. Courts may not simply impose their own notions of the day as to what is fair or unfair.”<sup>10</sup> This statement was aimed squarely at eliminating the “I know it when I see it” approach to defining unfair, and signaled the court’s insistence on applying a uniform standard of law that would govern liability in unfairness actions no matter which judge might hear the case.

The court in *Cel-Tech* sought to refine the “unfair” inquiry from what amounted to brute judicial fiat by prescribing a two-tiered approach. In the first tier, the court limited judicial discretion under the UCL by stating that “[i]f the Legislature has permitted certain conduct or considered a situation and concluded no action should lie, courts may not override that determination.”<sup>11</sup> The court referred to this legislatively-created unactionable area as a “safe harbor,” around which a plaintiff may not plead “by recasting the cause of action as one for unfair competition.”<sup>12</sup>

Though the “safe harbor” rule narrowed the scope of conduct actionable under 17200’s “unfair” prong, the court recognized that the rule did nothing to rein in the unfairness inquiry to be applied to conduct *outside* such “safe harbors.” Thus, it applied a second tier of unfairness analysis. First, *Cel-Tech* explains what is *not* an appropriate analysis. Citing the *Casa Blanca* and *Times Mirror*<sup>13</sup> standards, it criticized them generally as “too amorphous.”<sup>14</sup>

Vague references to ‘public policy,’ . . . provide little real guidance. These concerns led us to hold that to establish the tort of wrongful discharge in violation of public policy, the public policy triggering the violation must be tethered to a constitutional or statutory provision or a regulation carrying out statutory policy.<sup>15</sup>

Then, moving from general criticism of the older unfairness standards to the particular situation at issue in the case, the court “devise[d] a more precise test for determining what is unfair under the unfair competition law.”<sup>16</sup> Relying on federal FTC jurisprudence, the court adopted the following test:

When a plaintiff who claims to have suffered injury from a direct competitor’s “unfair” act or practice invokes section 17200, the word “unfair” in that section means conduct that threatens an incipient violation of an antitrust law, or violates the policy or spirit of one of those laws because its effects are comparable to or the same as a violation of the law, or otherwise significantly threatens or harms competition.<sup>17</sup>

Though the court had begun by broadly criticizing and dismissing pre-existing “unfair” standards as generally “too amorphous” to be of any worth, it enunciated a test specific to the direct competitor context of the case at hand. The court included a footnote, expressly limiting its discussion to the case before it, “an action by a competitor alleging anticompetitive practices.”<sup>18</sup> The court made clear that “[n]othing [it] sa[id] relate[d] to actions by consumers or by competitors alleging other kinds of violations of the unfair competition law.”<sup>19</sup>

Thus, essentially the court in *Cel-Tech* said that the old standards did not work and set forth a new standard for direct competitor antitrust cases, but it did not say exactly what new standard applies in non-competitor, non-antitrust cases. The lower courts knew that the broad old standards were no longer viable, but, in most cases, they did not know what should replace them.

## II. Decisions Since Cel-Tech

After the decision in *Cel-Tech*, two conflicting views of *Cel-Tech*’s teaching on “unfairness” emerged, with some cases relying on *Cel-Tech*’s general admonition

that the old standards were “too amorphous,” and others clinging to the old standards and trying to limit *Cel-Tech* or harmonize that decision with the *Times Mirror* and *Casa Blanca* tests. Recently, some courts have taken on these conflicting views and offered new approaches to the question, while awaiting further direction from the California Supreme Court.

### i. Cases Extending *Cel-Tech*

Some courts apply the *Cel-Tech* standard with little discussion, simply assuming or bluntly saying that it applies to all cases. For example, *Churchill Village, L.L.C. v. General Electric Co.*,<sup>20</sup> in examining a rebate program for dishwashers, quoted the *Cel-Tech* tethering language, and then dismissed, in a footnote, the argument that it was limited to competitor actions. “Although the California Supreme Court declined to extend its holding to consumer actions, the lack of distinction between competitor and consumer in the language of the UCL renders this definition equally valid in the consumer context.”<sup>21</sup>

Some other cases struggle to extend *Cel-Tech* outside the competitor versus competitor context. In *Schnall v. The Hertz Corp.*,<sup>22</sup> the California Court of Appeal examined two claims. The first was that Hertz had overcharged consumers for refueling their cars upon return. The court held this claim should be dismissed because California statutory law signaled the Legislature’s determination that the price should be left to the market and therefore Hertz was entitled to a “safe harbor” for its pricing decisions.

The second claim challenged whether Hertz’s refueling disclosures were proper. For that claim, the *Schnall* court “accept[ed] the suggestion of *Cel-Tech* that any claims of unfairness under the UCL should be defined in connection with a legislatively declared policy.”<sup>23</sup> Pointing to a civil code provision governing renters’ rights to disclosure of avoidable rental charges,<sup>24</sup> the court held that the plaintiff had stated a properly “tethered” unfairness claim.<sup>25</sup> But the *Schnall* court went on to argue, on the basis of *Times Mirror*, that generally in UCL “unfairness” actions, demurrer will be an improper method of claim disposal, and then quoted at length from the section of *Times Mirror* that includes its balancing test.<sup>26</sup> Overall, however, *Schnall* stands for a relatively expansive view of *Cel-Tech*, and signals acceptance of the “tethering” standard.

In *Gregory v. Albertson’s, Inc.*,<sup>27</sup> the California Court of Appeal also read *Cel-Tech* to require a “tethering” to a specific legislative policy whenever a 17200 unfairness claim was based on public policy, although the opinion still cites to the old standards as well. At issue in the case was a claim that the defendant grocery store and landlord were allowing a

piece of commercial property to sit vacant, thus creating a “blighted” neighborhood injurious to other nearby businesses. The court conceded *Cel-Tech*’s facial limitation to competitor cases: “Despite the [*Cel-Tech*] court’s earlier concerns that it found the definitions in *Casa Blanca* and *State Farm Fire & Casualty Co.*<sup>28</sup> to be ‘too amorphous’ for practical application, it limited application of its newly announced test to an action by a competitor alleging anticompetitive practices,”<sup>29</sup> and cited *Podolsky v. First Healthcare Corp.*,<sup>30</sup> for what is basically the *Casa Blanca* test: “A business practice . . . is unfair . . . if it offends an established public policy or . . . is immoral, unethical, oppressive, unscrupulous or substantially injurious to consumers.”<sup>31</sup> But *Gregory* then essentially disavowed the old standard:

*Cel-Tech*, however, may signal a narrower interpretation of the prohibition of unfair acts or practices in all unfair competition actions and provides reason for caution in relying on the broad language in earlier decisions that the court found to be ‘too amorphous.’ Moreover, where a claim of an unfair act or practice is predicated on public policy, we read *Cel-Tech* to require that the public policy which is a predicate to the action must be ‘tethered’ to specific constitutional, statutory or regulatory provisions.<sup>32</sup>

The court in *Scripps Clinic v. Superior Court*<sup>33</sup> agreed that *Cel-Tech* required all public policy-based 17200 unfairness claims to be “tethered” to legislative provisions. In *Scripps*, the plaintiff patients alleged that the defendant medical clinic’s practice of terminating patients’ care upon commencement of such patients’ malpractice suits against defendant was, *inter alia*, “unfair” under 17200. The court rejected plaintiffs’ arguments that their claim was tethered to the constitutional right to sue for malpractice, because that right was not abridged by defendant’s termination policy.<sup>34</sup> Then the court explicitly rejected plaintiffs’ alternative “unfairness” argument, based on the *Times Mirror* balancing test. Here, the plaintiffs argued that “physicians’ obligation to patients outweighs physicians’ loyalty to colleagues,” (upon which collegial loyalty defendant’s policy was based).<sup>35</sup>

“Even if we were inclined to determine that physicians’ duty to patients outweighs the duty to colleagues, we would not do so. As directed by the Supreme Court

in *Cel-Tech*: In ‘determining whether the challenged conduct is unfair within the meaning of the unfair competition law . . . , courts may not apply purely subjective notions of fairness. The appellate courts have neither the power nor the duty to determine the wisdom of any economic policy; that function rests solely with the legislature.’”<sup>36</sup>

Thus, *Scripps* flatly holds that unfairness claims must be tethered to a legislative or constitutional policy and that the balancing test is no longer valid.

## ii. Cases Narrowing *Cel-Tech*

A number of other courts have read *Cel-Tech*'s holding more narrowly. But even these cases show a clear movement away from the old tests and toward the *Cel-Tech* model. In *Smith v. State Farm Mutual Auto. Ins. Co.*,<sup>37</sup> insureds brought an action challenging an insurance company practice of refusing to permit waiver of uninsured motorist coverage with respect to individual vehicles or policies, instead requiring any waiver to be effective for all policies and all vehicles of a single insured. The court set out the *Times Mirror* and *Casa Blanca* tests and noted that *Cel-Tech* was limited to direct competitor cases,<sup>38</sup> but it also relied on the public policy expressed in the Insurance Code in an analysis similar to the “tethering” approved by *Cel-Tech*.

*Pastoria v. Nationwide Ins.*<sup>39</sup> used both the *Cel-Tech* case and a version of the older standards in reversing the sustaining of a demurrer. Plaintiff insureds alleged that the defendant had failed to disclose the insurance company's plan to make changes in the health care policies that plaintiffs had purchased. The court noted that the Insurance Code contained a potential statutory duty requiring defendant to make the disclosure about which plaintiff complained, so the “unfair” practice met *Cel-Tech*'s tethering test. *Pastoria* also used the test set forth in *Smith*, weighing the “competing interests” of the “impact” on the alleged victim against the “reasons, justifications and motives” of the defendant.<sup>40</sup>

*Progressive West Ins. Co. v. Superior Court*<sup>41</sup> most clearly rejects any extension of *Cel-Tech*. Examining a claim that the defendant insurance company “unfairly” sought reimbursement of insurance monies following the insured's recovery from third parties, the court used the old balancing test, noting that the California Supreme Court had “declined to extend [*Cel-Tech*'s] more narrow test to consumer cases . . . in the six years since that decision was announced.”<sup>42</sup>

## iii. New Approaches

Recently, some courts have gone further in fashioning a viable standard for unfairness in consumer cases. In *Bernardo v. Planned Parenthood Federation of America*<sup>43</sup> the court examined a claim that Planned Parenthood's website contained misleading and “unfair” statements regarding the safety of abortions. Analyzing whether dismissal of this claim was proper, the California Court of Appeal stated that “the law is unclear as to which definition of ‘unfair’ applies in consumer cases.”<sup>44</sup> After discussing *Cel-Tech* and the Court of Appeal decisions attempting to apply it, the court ultimately concluded that it “need not decide which test or definition of the term ‘unfair’ applies in the instant case” because “regardless of which applies, [plaintiff] failed to substantiate her claim.”<sup>45</sup> This seeming refusal to choose a standard is belied by the court's next sentence, however, which clearly refers to the *Cel-Tech* standard alone: “[Plaintiff] points to no legislative policy, or to any public policy ‘tethered’ to any specific constitutional, statutory or regulatory provision, which was allegedly offended or violated by Planned Parenthood's speech.”<sup>46</sup>

*Bardin v. Daimlerchrysler Corp.*<sup>47</sup> examined a claim that the auto manufacturer had “unfairly” included “inferior” metals in certain cars without adequately informing consumers. The court explicitly recognized the apparent “split” in authority on the proper definition of unfairness. It noted two differing lines of cases with differing definitions, one following *Smith* in declining to extend the *Cel-Tech* standard to consumer cases, and the other following *Scripps* in extending *Cel-Tech*. It then analyzed the claim under both standards, eventually holding that the claim could be properly dismissed on demurrer under either. Again, however, in the analysis purportedly under the *Casa Blanca/Smith* public policy test, the court narrowed the test to enable dismissal. And *Bardin* completely ignored the *Times Mirror* balancing test.

## III. An Emerging “New” Standard?

As the above discussion makes clear, the California Courts of Appeal have not settled on a clear, straightforward standard to be applied in non-competitor unfairness cases. However, the general direction of the law is apparent, and perhaps a “new” standard for what is required to sustain an “unfairness” case on behalf of consumers can be discerned.

First, most of the decisions at least implicitly admit that the *Cel-Tech* public policy “tethering” standard

should be a part of any analysis of an unfair claim. This is, of course, particularly true where the plaintiff has asserted other claims predicated on a statute, but the courts also will bring in relevant statutes, and conduct a fairness inquiry in light of them, as the court did in *Schnall*. Even those courts which explicitly declined to extend *Cel-Tech* outside the direct competitor context, still applied a public policy analysis that appears to be stricter than that required under the “old” characterizations of the *Casa Blanca* test. This is apparent in the *Smith*, for example.

Second, even though at least some courts have continued to cite to the broad balancing and “immoral, unscrupulous” tests of *Times Mirror* and *Casa Blanca*, it seems evident that *Gregory* is correct that, if those standards are applicable at all, they certainly cannot be read as broadly as they once were. An unfairness claim must rely on something more than a particular judge’s “gut reaction” to the challenged practice. *Gregory* is a good example of this, since it cites to *Times Mirror* but then essentially criticizes it, sending the analysis back to an examination of the public policy as expressed by the legislature.

*Pastoria* and *Progressive* are at odds with the prevailing view, and may not represent the correct law. The latter explicitly rejected *Cel-Tech* and applied the *Times Mirror* balancing test, with little or no recognition of the different direction other courts have taken. It is difficult to reconcile with the other cases. *Pastoria*, which also applied the *Times Mirror* test, is not so far afield. It analyzed the practice under *Cel-Tech* also and a close reading of *Pastoria* indicates that the balancing test, if viable at all, is now applied more strictly, placing an emphasis on the relative interests of the parties, rather than harm versus utility.

Finally, more recent cases like *Bernardo* and *Bardin* clearly show the influence of *Cel-Tech*. *Bernardo* and *Bardin* both applied what seems to be a “new” *Casa Blanca* test that is little different from the *Cel-Tech* standard. *Bardin* purported to examine the claims under both the old standards and the *Cel-Tech* “tethering” standard. But, in doing so, it essentially altered the pre-*Cel-Tech* definitions to mirror the concerns that prompted the California Supreme Court’s strong statements in *Cel-Tech*. These cases essentially ignore the old *Times Mirror* balancing test, and allow cases to be dismissed at the pleading stage.

#### IV. Conclusion

*Cel-Tech* logically and by its own terms should apply to eliminate the “old” standards of *Casa Blanca* and

*Times Mirror*. The opinion squarely criticizes those old standards as “amorphous” and does not limit that critical language to any particular type of unfairness case. However, the new standard announced by *Cel-Tech* was not extended by the California Supreme Court to anything but direct competitor cases.

That limitation has challenged the courts as they try to determine a new standard. The Supreme Court could, of course, choose to further develop the standard, applying *Cel-Tech*’s tethering standard to all cases (as *Scripps* did), or setting up a broader standard for some of them. It has not done so, however, despite increasingly explicit requests that it settle the differences.<sup>48</sup>

Thus, lower courts have created a patchwork of slightly different standards, but two trends emerge: (1) the existence of a specific public policy basis for the claim of unfairness, expressed through the Constitution, a statute or some other legislative or regulatory act, is probably a prerequisite for a viable unfairness claim and likely is now necessary to satisfy the *Casa Blanca* test, as modified by *Cel-Tech* and subsequent case law; and (2) the balancing test first articulated in *Times Mirror*, if applicable at all, has been narrowed to require some real unfairness on the defendant’s part and some particularized harm to plaintiff’s interest—manifest “unfairness”—that goes beyond the loss of money in the bargaining process. With this thorough development of the law, it is now time for the California Supreme Court to step in and provide a holding as to the proper scope of all “unfair” cases and the standard that controls them.

\* *Daniel K. Slaughter is a Special Counsel in the Consumer Litigation Practice Group of Heller Ehrman LLP in San Francisco. This article is adapted from an article that first appeared in Competition, The Journal of the Antitrust and Unfair Competition Law Section of the State Bar of California, Vol. 13, No. 2 and is used with permission.*

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**ENDNOTES**

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<sup>1</sup> 20 Cal.4th 163 (1999).

<sup>2</sup> No discussion of the UCL should ignore the amendments to the statute wrought by the passage in November 2004 of Proposition 64. Before Proposition 64, private parties could sue and obtain restitution on behalf of the “general public” without certifying a class, even if the named plaintiff had not been harmed by the defendant’s acts. Proposition 64 added a requirement that private plaintiffs must allege that they have been harmed and have lost money or property “as a result of” the alleged “bad” acts, and satisfy class certification requirements in order to represent others. The California Supreme Court is considering the issue of whether the new requirements apply to cases pending at the time of Proposition 64’s passage, and, if so, whether plaintiffs should be given leave to amend those suits to add new plaintiffs with standing. Courts have also begun to address whether the “as a result of” language imposes a new reliance and/or causation requirement in UCL cases, thus changing the standard for what is “fraudulent” from the old “likely to deceive” standard to a more concrete actual deception standard. *See Pfizer v. Superior Court*, --- Cal. App. 4th ---, 2006 WL 1892581 (July 11, 2006); *Laster v. T-Mobile USA, Inc.*, 407 F. Supp. 2d 1181, 1194 (S.D. Cal. 2005); *Anunziato v. eMachines, Inc.*, 402 F. Supp. 2d 1133 (C.D. Cal. 2005). These issues are beyond the scope of this article, but it will be interesting to see how Proposition 64 affects all aspects of UCL law, including the definition of “unfairness.”

<sup>3</sup> 102 Cal.App.3d 735 (1980).

<sup>4</sup> 102 Cal.App.3d at 740.

<sup>5</sup> *Id.*

<sup>6</sup> 159 Cal.App.3d 509 (1984).

<sup>7</sup> 405 U.S. 233 (1972).

<sup>8</sup> 159 Cal.App.3d at 530.

<sup>9</sup> 20 Cal.4th 163 (1999).

<sup>10</sup> *Id.* at 182.

<sup>11</sup> *Id.*

<sup>12</sup> *Id.* (internal quotations and citations omitted).

<sup>13</sup> The court actually cited a later case, *State Farm Fire & Casualty Co. v. Superior Court* (1996) 45 Cal.App.4th 1093, 1104, which had restated the *Times Mirror* test. *Cel-Tech*, 20 Cal.4th at 184.

<sup>14</sup> 20 Cal.4th at 185.

<sup>15</sup> *Id.*

<sup>16</sup> *Id.*

<sup>17</sup> *Id.* at 187.

<sup>18</sup> 20 Cal.4th at 187 n.12.

<sup>19</sup> *Id.*

<sup>20</sup> 169 F.Supp.2d 1119 (N.D. Cal. 2000).

<sup>21</sup> *Id.* at 1130 n.10.

<sup>22</sup> 78 Cal.App.4th 1144 (2000).

<sup>23</sup> *Id.* at 1166-67 (emphasis in original).

<sup>24</sup> Civil Code section 1936, subdivision (m)(2).

<sup>25</sup> 78 Cal.App.4th at 1166-67.

<sup>26</sup> *Id.* at 1167.

<sup>27</sup> 104 Cal.App.4th 845 (2002).

<sup>28</sup> *I.e.*, the *Times Mirror* test. See note 21, *supra*.

<sup>29</sup> 104 Cal.App.4th at 853.

<sup>30</sup> 50 Cal.App.4th 632 (1996).

<sup>31</sup> 104 Cal.App.4th at 854.

<sup>32</sup> *Id.*

<sup>33</sup> 108 Cal.App.4th 917 (2003).

<sup>34</sup> *Id.*

<sup>35</sup> *Id.* at 941.

<sup>36</sup> *Id.* (quoting *Cel-Tech*).

<sup>37</sup> 93 Cal.App.4th 700 (2001).

<sup>38</sup> *Id.* at 720 n.23.

<sup>39</sup> 112 Cal.App.4th 1490 (2003).

<sup>40</sup> *Id.* at 1498.

<sup>41</sup> 135 Cal.App.4th 263 (2005).

<sup>42</sup> *Id.* at 285-86.

<sup>43</sup> 115 Cal.App.4th 322, *cert. denied* 543 U.S. 942 (2004).

<sup>44</sup> *Id.* at 352.

<sup>45</sup> *Id.* at 353.

<sup>46</sup> *Id.* at 354.

<sup>47</sup> 136 Cal.App.4th 1255 (2006)

<sup>48</sup> *Bardin*, 136 Cal.App.4th at 1274 (“In light of the uncertain state of the law regarding the proper definition of ‘unfair’ in the context of consumer UCL actions, we urge the Legislature and the Supreme Court to clarify the scope of the definition of ‘unfair’ under the UCL.”).

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## **Federal Regulators and Department of Justice Investigating Lenders with Racial Disparities in Pricing Based on Federal Reserve**

### **HMDA Study**

by Andrew L. Sandler\*  
by Elizabeth E. McGinn\*

In September 2006, economists at the Federal Reserve Board ("Federal Reserve") released a statistical review of the 2005 Home Mortgage Disclosure Act ("HMDA") data (the "Fed Report"). This analysis both summarized the new information that could be gleaned from the 2005 HMDA data and provided a guide for screening and enforcement at the federal level. This followed a similar report by the Federal Reserve issued in September 2004.

The Fed Report provided information on the number of originated loans that were so-called "trigger loans" - i.e., first-lien loans with an APR that exceeded the applicable treasury rate by three points or more or subordinate-lien loans with an APR that exceeded the applicable treasury rate by five points or more.

The Federal Reserve did not have available data on credit and loan-to-value ratios, as such information is not reported under HMDA. However, other loan-level information, such as borrower income and loan amount, is available. Although this data paints only a partial picture, the Federal Reserve was nonetheless able to control for these variables in order to create a rough approximation of a true regression analysis. This analysis showed that the rates at which borrowers received higher-cost loans, on a matched basis, were higher for African-Americans, and Hispanics.

The Federal Reserve's analysis generated a list of approximately 270 lenders that had statistically significant disparities on a matched basis. As in 2004, the lenders on this list will be identified to their regulators (or the Department of Housing and Urban Development/Federal Trade Commission in the case of non-bank entities). In addition, the Department of Justice ("DOJ"), which has its own data analysis capabilities, was provided the list.

Various bank regulators have commenced investigations or examinations, and the DOJ has started several preliminary inquiries. Finally, state attorneys general also have commenced investigations of pricing discrimination, based on the 2004 HMDA data.

## **Federal Trade Commission and Other Agencies Focus on Mortgage Servicing Again as Private Litigation Increases**

by Andrew L. Sandler\*  
by Elizabeth E. McGinn\*

The Federal Trade Commission ("FTC") and other agencies have commenced investigations of mortgage servicers regarding potential unfair and deceptive trade practices. These investigations come in the wake of the FTC's \$40 million settlement with Fairbanks Capital Corporation in 2003 and the Office of Thrift Supervision's supervisory agreement with Ocwen Federal Bank FSB in 2004. As part of their respective agreements, both companies committed to a number of pro-consumer servicing practices, including appropriately investigating and responding to consumer complaints and updating the companies' force-placed insurance practices.

In addition, there have been a series of recent multi-million dollar trial verdicts in a number of states by individual plaintiffs alleging unfair and deceptive servicing practices, including a \$5 million judgment against Ameriquest and an \$11.5 million judgment against Ocwen. The magnitude of these verdicts increase the likelihood of further individual lawsuits and class actions being brought against mortgage loan servicers.

*\*Andrew L. Sandler and Elizabeth E. McGinn are members of the Consumer Financial Services Enforcement and Litigation practice in the Washington, DC office of Skadden, Arps, Slate, Meagher & Flom LLP. Their e-mail addresses are, respectively, asandler@skadden.com and emcginn@skadden.com.*

## **Unveiling the Modern Transaction of Simultaneously Entering into Service Contracts and Disclaiming Implied Warranties in Violation of the Magnuson- Moss Warranty Act**

by Christian Harris\*  
by Kevin M. Lemley\*\*

Congress enacted the Magnuson-Moss Warranty Act (“Magnuson-Moss”) to protect consumer rights. This article focuses on Section 2308(a), which prohibits a dealer from disclaiming implied warranties while simultaneously entering into a service contract or providing a written warranty.<sup>1</sup> A succession of cases developed concerning this provision as dealers seek methods to reap the profitability of providing service contracts but at the same time enjoy protection from implied warranty disclaimers. Courts have consistently seen through these schemes developed by dealers to skirt Magnuson-Moss obligations.

### **I. Overview of Section 2308(a)**

Section 2308(a) does not create new causes of action for consumers.<sup>2</sup> It permits consumers, in certain situations, to proceed with claims for breach of implied warranties under state law.<sup>3</sup> Consumers can bring these claims even though the good was sold “as is” and the consumer acknowledged written disclaimers of such warranties.<sup>4</sup> When all is said and done, these claims are breach of warranty claims. The complexity comes in procedural posturing to permit the consumer to bring these claims.

Section 2308(a) is a straightforward provision limiting the dealer’s ability to disclaim implied warranties:

No supplier may disclaim or modify (except as provided in subsection (b) of this section) any implied warranty to the consumer with respect to such consumer product, or (2) at the time of sale, or within 90 days thereafter, such supplier enters into a service contract with the consumer which applies to such consumer product.<sup>5</sup>

(Continued on Page 15)

Section 2308(a)(1) is clear: the dealer cannot make a written warranty and disclaim implied warranties.<sup>6</sup> The difficulty arises in the language of Section 2308(2) because Congress chose to use the phrase “enter into” rather than “sell” or “provide.” Under the language of the statute, it appears a dealer could sell or provide a service contract without entering into the service contract.<sup>7</sup> A dearth of authority exists expounding upon the “enter into” language of Section 2308(a)(2).<sup>8</sup>

The FTC promulgated one regulation regarding Section 2308(a).<sup>9</sup> This regulation provides a dealer may provide a third-party warranty without incurring liability under the warranty.<sup>10</sup> However, the dealer may become obligated under Magnuson-Moss by making written representations, oral representations, or through other actions connected with the sale.<sup>11</sup> Through such representations or actions, the dealer may adopt the provided warranty.<sup>12</sup> This regulation was issued at a time when service contracts were less prevalent. It only discusses warranties without specific reference that the regulation applies to service contracts.<sup>13</sup> Because Section 2308 affords consumers the same protections whether a written warranty or a service contract is involved, this FTC ruling applies with equal force to service contracts.

Section 2308(a)(2) is a significant provision affecting consumer rights, and the incorporated language has fostered the modern transaction used by dealers, discussed in Section IV, *infra*. Before evaluating the scope of Section 2308(a)(2), it is imperative to analyze the history of Magnuson-Moss.

### **II. Legislative History and Case Law Interpretation of Section 2308(a)**

The Federal Trade Commission (“FTC”) conducted an investigation on dealer warranties.<sup>14</sup> The FTC found dealers failed to perform their warranty obligations and were not living up to their promises.<sup>15</sup>

Congress was also concerned with dealers selling service contracts.<sup>16</sup> Congress noted that service contracts are often “overpriced and designed solely to increase the margin of profit on the sale.”<sup>17</sup> Moreover, these service contracts are “devised simply as a means for increasing sales and contain illusory promises which will not provide the consumer with any real protection.”<sup>18</sup> In light of these problems, Congress enacted Magnuson-Moss to provide “safeguards against the disclaimer or modification of the implied warranties of

## **Unveiling the Modern Transaction of Simultaneously ...** (Continued from Page 14)

merchantability and fitness on consumer products where a written warranty is given with respect thereto.”<sup>19</sup>

In explaining the purpose behind Section 2308(a), Congress was particularly concerned because dealers used this practice to mislead consumers and restrict consumer rights:

This subsection is designed to eliminate the practice of giving an express warranty while at the same time disclaiming implied warranties. This practice often has the effect of limiting the rights of the consumer rather than expanding them as he might otherwise be led to believe.<sup>20</sup>

Congress also recognized consumers did not have practical means of forcing dealers to live up to their commitments.<sup>21</sup> To alleviate this problem, Magnuson-Moss provides for a successful plaintiff to recover an aggregate amount of costs and expenses, including attorney’s fees.<sup>22</sup>

Litigation involving Section 2308(a) has resulted in a line of cases that illustrates both the dealers’ increasingly creative attempts to skirt Magnuson-Moss and the courts’ unwillingness to permit the dealers to dodge their responsibilities. Each case has an underlying commonality: they all involve a dealer employing an artful transaction to skirt obligations under Magnuson-Moss. This section of the article traces the evolution of the case law.

### **i. Dealers Provided Consumers with Manufacturer Warranties, but the Dealer Was Obligated to Perform Under the Warranty**

In four early cases, dealers disclaimed implied warranties. But they simultaneously gave the consumer a manufacturer warranty<sup>23</sup> or an “owner service policy”<sup>24</sup> that obligated the dealer to perform service. This scheme was unfair because the dealers were providing warranties even though the warranties officially belonged to the manufacturers. The courts recognized this and held the implied warranty disclaimers were invalid.

This line of cases showed that Section 2308 receives an expansive interpretation. Dealers are deemed to have provided a written warranty if the dealer is obligated under the manufacturer warranty. The courts showed a willingness to examine the true substance of the transaction rather than the form.

After these attempts at providing manufacturer warranties failed, dealers employed a new scheme: incorporate the warranty into the underlying sales transaction. This attempt was also unsuccessful.

### **ii. Dealers Would not be Obligated Under the Manufacturer’s Warranty, but the Warranty Would Be Included in the Underlying Vehicle Sale**

Under this scheme, dealers would provide the consumer with a manufacturer warranty. The warranty would not obligate the dealer. However, the dealer incorporated the warranty into the underlying sales contract for the vehicle.<sup>25</sup> The *Felde* court held the implied warranty disclaimers were invalid, basing its ruling on the FTC regulation.<sup>26</sup> The *Felde* decision continued the expansive interpretation of Section 2308 as set forth by the FTC and earlier courts. After *Felde*, the courts had effectively eliminated any profitability for the dealers of providing third-party warranties. With all avenues closed on providing warranties, dealers turned to selling third-party service contracts.

### **iii. Dealers Sold Third-Party Service Contracts, but the Dealer Was Obligated to Perform Under the Service Contract**

Dealers advanced to selling third-party service contracts, but the dealer itself was obligated to perform the service.<sup>27</sup> The courts treated this scheme just as dealers providing third-party warranties that obligated the dealer, and they rejected the implied warranty disclaimers. The *Patton* court made an observation regarding the history of Magnuson-Moss: “There is no indication in the language or legislative history of the Magnuson-Moss Act that the service contract must originate with or be the sole responsibility of the dealer.”<sup>28</sup>

A dealer in Arizona put a slightly different twist on the transaction, but the result was the same.<sup>29</sup> Earnhardt sold the car “as is” except for a temporary warranty.<sup>30</sup> The service contract expressly stated it was a contract between the consumer and service provider.<sup>31</sup> However, the service contract directed the consumer to obtain service from the dealer.<sup>32</sup> The dealer also made oral representations that it would perform service.<sup>33</sup> The court reversed the summary judgment granted to the dealer.<sup>34</sup> By doing so, the court seemed to apply the FTC regulation on warranties to service contracts.<sup>35</sup>

This line of cases demonstrates two important points. First, it exemplifies the profitability dealers enjoy from selling service contracts. Dealers are willing to

bring in a third party and take a diminished percentage of the service contract sale. The value is still there for the dealer. Second, courts continued their pattern of expansive interpretation of Magnuson-Moss by examining the true substance of the transaction rather than the form. Dealers were merely filtering the service contracts through third parties. The dealers were essentially "entering into" service contracts. The failure of this transaction model has given way to the modern transaction where the dealer's obligations are concealed from the consumer.

**iv. Dealers Removed Reference to Their Obligations from the Face of the Service Contract Provided to the Consumer**

Dealers now employ the modern transaction where dealers conceal their service contract obligations from the consumer. The service contract provided to the consumer contradicts the dealer's contractual relationship with the third-party service contract provider. The dealer is obligated either to perform service or to be financially responsible for any repairs made. The only case analyzing the modern transaction model is *Lemons v. Showcase Motors, Inc.*<sup>36</sup> Ms. Lemons bought a Dodge Durango from Showcase.<sup>37</sup> Showcase sold the vehicle "as is."<sup>38</sup> Showcase simultaneously sold Ms. Lemons a service contract by Mechanical Protection Plan ("MPP").<sup>39</sup> Ms. Lemons never spoke to MPP; instead, Showcase conducted all dealings with Ms. Lemons regarding the service contract.<sup>40</sup> Showcase had no obligations on the face of the service contract, but Showcase's contract with MPP demonstrated that Showcase was the true contracting party:

. . . [Showcase] shall be the sole contracting party with customers under all Service Contracts and MPP Co., Inc. shall have no liability to customers. MPP Co., Inc. assumes no obligations, duty or liability with respect to Dealer's performance under said Contracts.<sup>41</sup>

Of course, Showcase's consumers were unaware of the Showcase-MPP contract and its contradiction of the consumer-MPP contract.<sup>42</sup> Ms. Lemons did not obtain the Showcase-MPP contract until after Showcase won summary judgment against her.<sup>43</sup> The court reversed the grant of summary judgment.<sup>44</sup> Once again, the court seemed to apply the FTC regulation on warranties to service contracts.

Each dealer in the above cases was unsuccessful because: (1) they created an artful transaction to try

to skirt Magnuson-Moss; and (2) they failed to divorce the service contract or warranty from the underlying sales contract. In every case, the court employed a broad application of Section 2308 to serve the Congressional intent behind Magnuson-Moss. This same approach should be applied to the modern transaction.

**III. Evaluating the Role of the Service Contract in the Modern Transaction<sup>45</sup>**

The modern transaction begins with the disclaimer of implied warranties. The dealer sells the automobile "as is" to the consumer. These disclaimers are clear on the sales contract and other documents related to the sale. These disclaimers are standard implied warranty disclaimers, but the nature of the service contract and its role in the sale transaction makes these disclaimers invalid.

**i. The Nature of the Service Contract**

The dealer presents the service contract to the consumer at the point of sale. Usually the consumer has a choice of several different service obligors, each having several different service contracts available. This "choice" is largely irrelevant because the transaction is the same no matter which contract the consumer selects. There are several key elements to examine in the service contract, each of which will be discussed in turn.

*a) The Fiction of an Application*

The service contract is set up as an "application." It states that the consumer and the service obligor are the two contracting parties. According to the face of the contract, the dealer signs as the service obligor's agent. However, this concept of the service contract being merely an application is a fiction.<sup>46</sup> The "application" is never rejected by the service obligor. It is important to note here that the consumer never negotiates or communicates with the service obligor. All discussions regarding the service contract such as price, terms and conditions are made solely with the dealer at the dealer's place of business.

*b) The Fine Print of the Service Contract*

The fine print of the service contract reveals several key provisions showing the service contract is incorporated into the sales contract. First, the consumer can only purchase the service contract on the date of the sale of the automobile. Second, the consumer's obligations are often split between the dealer and service obligor. For instance, the consumer usually must contact the service obligor to obtain service, but the consumer must contact the

dealer to cancel the contract. If the contract is truly between the consumer and the service obligor, why would the consumer have any future contact with the dealer regarding the service contract? Third, the service contract will provide interim services for the service obligor to perform, such as providing a rental car to the consumer. In many circumstances, the dealer will perform all or some of the service obligor's obligations under the service contract.

*c) The Dealer's Percentage of the Service Contract Price*

The service contract is not cheap; even a basic service contract will cost the consumer \$1,500 or more. The dealer retains a significant percentage of the service contract price, often in the range of 20%. This percentage retained is pure profit for the dealer. More importantly, this percentage considerably enhances the dealer's profits on the transaction. If the dealer nets an \$800 profit on the automobile sale price, the retained percentage of the service contract adds another \$300 or more of profit. This added profitability makes the modern transaction extremely valuable to the dealer.<sup>47</sup>

**ii. The Sales Contract**

The sales contract is a standard contract that provides all the requisite truth in lending disclosures. The sales contract contains certain provisions that alter consumer rights. In the fine print, the sales contract is immediately assigned to the lender. Once litigation ensues, the dealer will rely on this provision that the dealer is not the proper party to be sued. More importantly, the service contract will contain an arbitration clause for any claims between the consumer and the lender. While the arbitration will be held close to the consumer, the applicable law will be the law of lender's home jurisdiction. This automatic assignment is irrelevant to a claim based on Section 2308; only the dealer can violate Section 2308.

**iii. Incorporating the Service Contract into the Sales Contract**

The most important component of the modern transaction is the incorporation of the service contract into the underlying sales contract. This incorporation merges the two contracts into one single transaction. The incorporation is clear from the face of the sales contract. The service contract price becomes part of the total price of the transaction between the consumer and the dealer. The sales contract highlights this feature because the sales contract discloses the sale price, down payment, trade-in value and the service contract price. All these figures are combined to reach the "total sale price" or "total amount financed." Additionally, the sales contract

shows that interest begins running on the entire purchase price, which includes the service contract price, on the date of sale. There is no provision in the sales contract for the service obligor to "reject" the "application," and there is no provision to refund the consumer the service contract price in the event of "rejection." Moreover, the sales contract is styled as the "application for credit" to the lender. This "application" is also a fiction because the lender has approved financing before the sale is reduced to a written contract. Even if the sales contract was truly an application, the service contract price becomes part of the application because it is included in the total amount of financing requested in the application.

Finally, a common sense approach demonstrates the incorporation of the service contract into the sales contract. There is no separate payment from the consumer to the service obligor. If these contracts are in fact two separate contracts, the consumer should pay for the service contract separate and apart from the automobile purchase. A separate payment is simply not possible on two grounds. First, as discussed above, service contracts are not cheap. Few consumers can afford to pay for the service contract out-of-pocket. For the typical consumer, the only way to purchase the service contract is to roll it into the sales contract. Second, separately paying the service contract does not make sense given the mechanics of consumer good financing. Even if the consumer could afford to pay the service contract out-of-pocket, it would not behoove the consumer to do so. The consumer's interest rate on the financing loan is dictated in part by the amount of the down payment. It is more cost effective for the consumer to add the service contract price to the car note and then make a larger down payment. It is either impossible or impractical for the consumer to make a separate payment on the service contract.

**iv. The Dealer and Service Obligor Keep Their Relationship Secret from the Consumer**

The relationships between the dealer and service obligor are kept secret from the consumer. This secrecy is crucial for the modern transaction to work. A written contract exists between these parties concerning the service contract (hereafter "undisclosed contract"). The terms of the undisclosed contract will vary depending on the particular service obligor. The undisclosed contract may require the dealer to guarantee all service the dealer will perform pursuant to the service contract, or it may require the dealer to bear ultimate financial responsibility for service performed. The undisclosed contract may be filtered through the lender. In this situation, the

undisclosed contract exists between the service obligor and lender, but the dealer's contract with the lender obligates the dealer to take responsibility for the lender's obligations.

The undisclosed contract makes the dealer the true contracting party with the consumer in the service contract. The service obligor only serves as a third-party filter so the dealer can simultaneously disclaim implied warranties and significantly profit from the sale of service contracts. As a result, the dealer fiercely guards the existence of the undisclosed contract. In *Lemons* the undisclosed contract was eventually revealed, but only after summary judgment was granted to the dealer.<sup>48</sup> Even without disclosure of the undisclosed contract, a common sense approach necessitates the existence of the undisclosed contract. Service contracts remain in effect for thousands of miles and/or several years. This is a significant obligation to make to the consumer. It is difficult to imagine the dealer could obligate the service obligor to such a contract without a written agreement between the dealer and service obligor.

#### **IV. The Modern Transaction Violates Magnuson-Moss**

Magnuson-Moss prohibits a dealer from disclaiming implied warranties while simultaneously entering into a service contract or providing a written warranty.<sup>49</sup> The modern transaction should be construed as the dealer entering into the service contract with the consumer. While no court has yet to make this determination, the landscape of Magnuson-Moss litigation and legislation supports this conclusion.

First, the legislative history of Magnuson-Moss illustrates a clear congressional intent to provide additional protection for consumers.<sup>50</sup> This intent suggests Magnuson-Moss should receive expansive interpretation in favor of the consumer. Courts have applied this expansive interpretation when analyzing previous transactions to evade Magnuson-Moss. The common underlying theme among Magnuson-Moss cases is that Section 2308 is interpreted broadly to determine whether the dealer entered into the service contract or provided a written warranty.<sup>51</sup>

Second, the FTC proclaimed stated dealers could adopt a warranty through actions, written representations or oral representations.<sup>52</sup> The FTC did not address service contracts, but there was no need to issue a ruling on service contracts at that time. This ruling was issued in 1977, before dealers turned to selling service contracts to evade their obligations under Magnuson-Moss.<sup>53</sup> The FTC had no reason to regulate service contracts. Because Section 2308 affords consumers the same protections whether a

written warranty or a service contract is involved, the FTC ruling should apply with equal force to service contracts. Therefore, dealers can adopt, i.e. enter into, service contracts through actions, written representations or oral representations. Without expressly adopting this FTC provision, courts have held dealers may adopt service contracts through written or oral representations.<sup>54</sup>

Third, the modern transaction incorporates the service contract into the underlying sales contract. These contracts are executed at the same time (the service contract can only be sold on the date the automobile is sold). Moreover, the service contract price is merged into the sales contract, with the consumer making payments to the lender on the combined total. There is no separate payment for the service contract.

Fourth, a practical evaluation also reveals the modern transaction violates Magnuson-Moss. The purpose behind Magnuson-Moss is to provide redress to consumers. Attorney's fees are provided in the statute so consumers can obtain this redress through the courts. If the dealer has assumed obligations under the service contract, the consumer has a right to discover the dealer's relationship with the service contract. The modern transaction deprives the consumer of this knowledge by hiding the true nature of the service contract from the consumer. It would be impossible for the consumer to discover this relationship without knowing which documents to aggressively seek during discovery.

#### **V. Conclusion**

The modern transaction provides dealers the twin benefits of disclaiming implied warranties and generating substantial profit from selling service contracts. Congress intended to eliminate these types of transactions by enacting Magnuson-Moss.

Prior case law and FTC regulations demonstrate an expansive interpretation of Magnuson-Moss. The modern transaction should be deemed as the dealer "entering into" a service contract, and the accompanying implied warranty disclaimers should be held invalid.

\* *Christian Harris, [charris@allenlawfirmnpc.com](mailto:charris@allenlawfirmnpc.com), an associate with the Allen Law Firm, focuses on commercial litigation and appellate matters.*

\*\* *Kevin M. Lemley, [kmlmley@allenlawfirmnpc.com](mailto:kmlmley@allenlawfirmnpc.com), an associate with the Allen Law Firm, focuses on commercial litigation and intellectual property litigation.*

ENDNOTES

<sup>1</sup> 15 U.S.C. § 2308(a).

<sup>2</sup> 15 U.S.C. § 2308(c).

<sup>3</sup> 15 U.S.C. § 2308.

<sup>4</sup> *See id.*

<sup>5</sup> *See* 15 U.S.C. § 2308(a).

<sup>6</sup> *See* 15 U.S.C. § 2308(a)(1).

<sup>7</sup> Christopher Smith, *Service Contracts Under the Magnuson-Moss Warranty Act*, 346 PLI/Comm 185, 194 (1985).

<sup>8</sup> Roger D. Billings, Jr., *HAND. AUTO. WARR. & REPOSS.* § 7: 36.50 (2d ed. West 2005).

<sup>9</sup> 16 C.F.R. § 700.4.

<sup>10</sup> *Id.*

<sup>11</sup> *Id.*

<sup>12</sup> *Id.*

<sup>13</sup> *Id.*

<sup>14</sup> H.R. No. 93-1107 (1974), *reprinted in* 1974 U.S.C.C.A.N. 7702, 7708.

<sup>15</sup> *Id.*

<sup>16</sup> *Id.* at 7710.

<sup>17</sup> *Id.*

<sup>18</sup> *Id.* at 7711.

<sup>19</sup> *Id.*

<sup>20</sup> 1974 U.S.C.C.A.N. at 7722.

<sup>21</sup> *Id.* at 7710.

<sup>22</sup> 15 U.S.C. § 2310(d)(2).

<sup>23</sup> *Henderson v. Benson-Hartman Motors, Inc.*, 33 Pa. D & C 3d 6 (C.P. Allegheny Cty. 1983); *Freeman v. Hubco Leasing, Inc.*, 324 S.E.2d 462, 465-66 (Ga. 1985).

<sup>24</sup> *Ventura v. Ford Motor Corp.*, 433 A.2d 801, 809 (N.J. Sup. 1981); *Rothe v. Maloney Cadillac, Inc.*, 492 N.E.2d 497, 503 (Ill.App. 1<sup>st</sup> Dist. 1986), *aff'd in part and rev'd in part on other grounds*, 518 N.E.2d 1028 (Ill. 1988).

<sup>25</sup> *Felde v. Chrysler Credit Corp.*, 580 N.E.2d 191, 197 (Ill.App. 2<sup>nd</sup> Dist. 1991).

<sup>26</sup> *Id.* at 197; *see also* 16 C.F.R. § 700.4.

<sup>27</sup> *Patton v. McHone*, 822 S.W.2d 608, 612 (Tenn.App. 1991); *Ismael v. Goodman Toyota*, 417 S.E.2d 290, 291-92 (N.C.App. 1992).

<sup>28</sup> *Patton*, 822 S.W.2d at n. 16.

<sup>29</sup> *Johnson v. Earnhardt's Gilbert Dodge, Inc.*, 111 P.3d 417, 423 (Ariz.App. 1<sup>st</sup> Div. 2005).

<sup>30</sup> *Id.* at 418.

<sup>31</sup> *Id.* at 419.

<sup>32</sup> *Id.*

<sup>33</sup> *Id.* at 420.

<sup>34</sup> *Id.* at 423.

<sup>35</sup> *See Johnson*, 111 P.3d at 423.

<sup>36</sup> *Lemons v. Showcase Motors, Inc.*, 88 P.3d 1149 (Ariz.App. 1<sup>st</sup> Div. 2004).

<sup>37</sup> *Id.* at 1150.

<sup>38</sup> *Id.*

<sup>39</sup> *Id.*

<sup>40</sup> *Id.* at 1151.

<sup>41</sup> *Id.* at 1153.

<sup>42</sup> *See Lemons*, 88 P.3d at 1152.

<sup>43</sup> *Id.* at 1152.

<sup>44</sup> *Id.* at 1152-53.

<sup>45</sup> The modern transaction has been illustrated to a degree in *Lemons* and treatises cited in this section. A substantial amount of information regarding the modern transaction stems from the authors' experience in Section 2308 litigation.

<sup>46</sup> Jonathan Sheldon and Carolyn L. Carter, *CONSUMER WARRANTY LAW*, § 2.3.2.2 (2d ed. NCLC 2001).

<sup>47</sup> See *id* (describing dealers as having a “huge profit margin” on service contracts).

<sup>48</sup> *Lemons*, 88 P.3d at 1152-53.

<sup>49</sup> 15 U.S.C. § 2308(a).

<sup>50</sup> See H.R. No. 93-1107 (1974), reprinted in 1974 U.S.C.C.A.N. 7702.

<sup>51</sup> See discussion, Section II, *supra*.

<sup>52</sup> 16 C.F.R. 700.4.

<sup>53</sup> See *id*.

<sup>54</sup> See, e.g., *Patton*, 822 S.W.2d 608; *Ismael*, 417 S.E.2d 290; *Johnson*, 111 P.3d 417.



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## Supreme Court Issues a Favorable Ruling to the Consumer Financial Services Industry Concerning Use of Mandatory Arbitration Clauses in Contracts

by Andrew L. Sandler\*  
and Elizabeth E. McGinn\*

In a major decision involving the enforcement of arbitration agreements, the Supreme Court held, in February 2006, that a challenge to the legality of a contract that contains an arbitration clause must be determined by an arbitrator, rather than a court.

The case, *Buckeye Check Cashing, Inc. v. Cardegna*, No. 04-1264, involved a challenge to a "payday" loan contract that contained an arbitration clause. The plaintiff claimed that the underlying contract was illegal because it charged usurious interest rates and violated various state lending and consumer protection laws. The plaintiff also argued that it had the right to challenge the contract's illegality in court, rather than submit the issue to arbitration. The Supreme Court, however, held by a 7-1 vote that the arbitrator, not the courts, should adjudicate the issue of the contract's legality.

*\*Andrew L. Sandler and Elizabeth E. McGinn are members of the Consumer Financial Services Enforcement and Litigation practice in the Washington, DC office of Skadden, Arps, Slate, Meagher & Flom LLP. Their e-mail addresses are, respectively, asandler@skadden.com and emcginn@skadden.com.*



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