CHAPTER FOUR

Special Contract Terms

YOU'VE NOW LEARNED THE BASICS of consumer contract law. With this foundation, you should be able to appreciate this chapter=s discussion of types of contract terms that are often part of consumer contracts, but were put there for the seller's benefit. You may be able to bargain these terms away. But as often as not, you=ll be given a "standard"(form) contract and little choice if you want the product or service being offered. If, however, you understand these terms, you=ll be better able to evaluate whether the deal really is worth it to you. And if you do go ahead, you=ll know where some of the potential problems are.

As discussed earlier, because these terms are usually found in form contracts -- which are often take-it-or-leave-it contracts of adhesion -- there could be a chance of being excused from performing them if the terms in question are ambiguous. That, however, is a fall-back position. At the outset, you have to act as if you=re going to be held to every word in every contract you sign, because you well might.

We will focus on a number of the most important terms, especially the various types of **waivers**. You have given a waiver when you have knowingly surrendered (waived) one of your rights. After reading this chapter, you should have a good idea of what these types of clauses are about when you see them.

ARBITRATION CLAUSES

Arbitration clauses are one kind of waiver. If they are binding, they surrender any legal right to sue the company you're contracting with. Instead, you agree to submit to **binding** (final) **arbitration**, the most common form of **alternative dispute resolution**, or ADR. Arbitration is especially common in brokerage contracts.

Arbitration is not a bad thing. Sometimes it can be to a consumer's advantage. It gets rid of a lot of the formalities and technicalities of court proceedings, and is often much faster and cheaper. There are some areas, however, where seemingly simple issues are really much more complex than they appear. Then arbitration might cause problems. And there is usually no appeal from binding arbitration except perhaps for fraud.

Thus, to use the securities industry as an example, let's say you have a dispute with a stockbroker over how he or she executed your instructions on a transaction, or you are dissatisfied with the general handling of your account (too many trades, for instance). Obviously you would begin by contacting the broker directly, and then, as necessary, go up the line through supervisors to try to get satisfaction. (You may be surprised at how willing reputable brokerages are to help customers who are dissatisfied with their service.) If all attempts at amicable settlement fail (this whole technique will be discussed more fully in chapter 15), you might finally decide that you want to sue to enforce your legal rights, and perhaps go as far as letting a jury see who is right.

But you cannot, because of the arbitration clause found in virtually all brokerage agreements. It probably reads something like this:

Subject to the limitations of federal or state law, any controversy arising out of or

relating to my accounts, to transactions with you for me or to this agreement, or breach thereof, shall be settled by arbitration in accordance with the rules then in effect at the National Association of Securities Dealers, the New York Stock Exchange, or the American Stock Exchange.

You don=t have much choice about this clause, or one like it. It is in use by virtually every brokerage, in every type of trading. Whether it=s buried in an eight-page ANew Account Agreement@ full of dotted lines to sign, or even if it=s brought to your attention in bold type, there is no way out of it in most brokerage contracts.

The associations and boards that most brokerage contracts designate as arbitrators are not governmental. They are made up of members of industries that the government regulates, as a form of Aself-regulation.@ AThe rules in effect@ for arbitration at these various boards are not unfair. But arbitrations under the rules of these boards may not be as objective for consumers as those of the best-recognized arbitration organization, the American Arbitration Association, or AAA.

Some arbitration clauses are more or less restrictive than the one quoted above, because they include other elements -- such as a waiver of any right to punitive damages -- that will be discussed below. Others, such as the one used in the commodities-trading industry, give customers a 45-day Awindow@ -- 45 days after a dispute arises to go to court, before losing that right. That=s better than nothing. But compared to the six years you may have under a statute of limitations for breach of contract, 45 days is not much time.

The fact is that if you want to invest through brokerages, especially where you want the option of margin trading on credit provided by the brokerage, you must sign this agreement. Some brokerages

say that Acash account@ customers, who trade only with money deposited with the broker and not on margin, do not need to submit to arbitration. But few brokers will present this option to you. If, however, you know that you don=t want margin trading -- which offers investors unique opportunities, with corresponding risks -- try to get a brokerage agreement without mandatory arbitration.

As of today, every court will uphold an arbitration clause, citing a general policy in favor of avoiding litigation by use of arbitration. Because of this standing rule favoring arbitration, arbitration clauses are an important exception to the principles discussed in chapter 3 about contracts of adhesion. This is one clause you really are Astuck with.@

Arbitration clauses are found not only in brokerage contracts. One recent Alabama case upheld the right of a pest extermination company to enforce an arbitration clause in its consumer service contracts. They are becoming more common in consumer credit contracts as well. Companies like these clauses because arbitration is less expensive than litigation, and arbitration awards to consumers are usually less than jury awards.

If you are in a situation where you do have some bargaining power -- again, probably not in the securities or credit areas -- you can try to make an arbitration clause as fair as possible. One way is to agree to arbitration only under AAA auspices, which are generally regarded as the fairest.

Sidebar

REQUIREMENTS FOR ARBITRATION CLAUSES

Different states have different requirements that an arbitration clause must meet to be enforceable. Some have no special requirements at all, reflecting a policy favoring arbitration. In California, however, consumers must *knowingly* waive their right to a jury trial. Furthermore, California now requires that an arbitration clause appear in a Aclear and unmistakable form@ in the contract, such as by highlighting, bold type, or by indicating a place for the consumer to indicate that he has read it. Other states have similar laws. You should investigate your state=s laws or speak to a lawyer.

Companies that are members of the New York Stock Exchange are also subject to specific requirements for arbitration clauses. NYSE rules require that arbitration clauses tell consumers:

- that arbitration is final and binding;
- that the parties are waiving their rights to seek remedies in court;
- that pre-arbitration **discovery** (trading of documents and information) is different and more limited than that available in court proceedings;
- that arbitrators are not required to spell out the legal or factual bases for their decisions, which are virtually unappealable; and
- that a minority of the arbitration panel will be made up of present or former members of the securities industry.

FORUM-SELECTION CLAUSES

The Aplace@ you go for legal relief -- a court, for example -- is a forum. You are being told what Aplace@ can adjudicate claims or disagreements about a contract.

Generally speaking, **forum-selection clauses** limit the parties (or, sometimes, just one party!) to a certain state, or federal district, where lawsuits may be initiated. The right to choose the forum in which to sue can be a very important right. Where there is no forum-selection clause, with some limitations courts give the plaintiff the right to choose which forum to sue in.

For example, let=s say you are a resident of Biloxi, Mississippi, who enters into a contract with the Waffle-Iron of the Month Club in Brooklyn, New York. You get into a dispute with the company when, in response to your order for a Barney the Dinosaur waffle-iron, they send one shaped like Dino the Dinosaur. Junior is horrified, and you object to the company. They refuse to refund your money or even exchange the iron, claiming that all purple dinosaurs are alike. You decide to sue. Legally, you could, at the very least, choose to sue the club in either Brooklyn, where the company is, or Biloxi, where you are. The courts traditionally defer to the forum choice of the person who starts the lawsuit, if the chosen forum is technically correct.

So where would you choose? Chances are, even if you felt completely Acomfortable@ with the New York court system, you wouldn=t want to take the time and expense to find a New York lawyer or trot over to New York yourself to make your case -- especially for a $13 waffle iron. Even on principle. But in Mississippi, you might be willing to go through the trouble.

But take a good look at your agreement with these wafflers. Is there a forum-selection clause? If there is, it might require you to bring a lawsuit only in Kings County (Brooklyn) in the State of New York. For you, in this example, that=s as good as taking away your right to sue. It=s now utterly impractical to sue.

Forum-selection clauses aren=t always so strict, but they can be. The courts routinely enforce

them, though there=s a smidgen more scrutiny applied to them than with arbitration clauses. It=s not enough to matter, for our purposes.

There is an important difference, though, between forum-selection clauses and arbitration clauses. There is more variation of forum-selection clauses among types of contracts. If you=re in a position where bargaining is not practical, you may very well be able to get what you want from another service or goods provider without a forum selection clause, or without one as limiting. And, of course, remember that if the forum selection clause requires you to use the courts of your own state, you=re probably not giving up much by agreeing to it.

CHOICE-OF-LAW CLAUSES

Another common kind of waiver in form contracts is one that designates which state=s legal doctrines and substantive laws will govern interpretation of the document, or any dispute over it. This is called a **choice-of-law** clause. Because it is so frequently found in form contracts used by big companies, it is also hard to negotiate away. You should, therefore, understand what these clauses do.

Every state in the Union, as well as the District of Columbia and each territory and other jurisdiction in the U.S., has its own laws. Making those laws is what each state=s legislature, courts and administrative bodies do. Part of the Afederalism@ system is that the democratically elected lawmakers of each state make laws that, within the bounds of the U.S. Constitution, reflect the policy preferences of the people of that state. In many states, the substantive law reflects a traditional approach in that state, which, short of a voter uprising, remains central to its legal tradition. States also have to consider what their legal

regime offers to businesses that have the right to set up shop wherever the Alegal climate@ is most favorable to them. Therefore, different states have different approaches to contract interpretation, consumers= rights, and the like. Some are very pro-consumer, others are very pro-business.

For a company doing business all over the country, having to contend with the laws of many states is fraught with difficulty. Designating a choice of law provides a measure of predictability when you know that you only have to consider the legal doctrines of one jurisdiction, instead of some greater number whose law might be applied without an agreement. For companies that have many thousands of similar contractual relations that can mean a considerable cost savings as well.

The traditional rule regarding contracts is that, regardless of where a lawsuit over that contract is begun, the law that will be applied in the suit is either the place where the contract is made or the place where the parties intended it to be performed. The latter is often more persuasive if the contract was signed in a geographically convenient neutral ground or a place that has little to do with the contractual relationship.

The choice of which law applies in interpreting and enforcing a contract is called the choice of **substantive** law. Substantive law is contrasted with **procedural** law. The applicable procedural law is always the law of the forum. Thus, you could have a Pennsylvania court applying California law to a contract, but the procedural law -- the technical rules and procedures by which a court proceeding is governed -- will remain Pennsylvanian. (Understanding this, incidentally, can give you some insight into one reason a party might prefer a given forum, as discussed above: choice of forum equals choice of procedural rules.)

As a consumer, you obviously would prefer to make your legal claim in a pro-consumer state.

The **choice-of-law** clause often given businesses their preferences. Typically, the clause will simply say,

> *All disputes arising out of this contract shall be determined in accordance with the law of the State of New York.*

The choice in the example was no accident, by the way. Most lawyers agree that New York=s law is very favorable to business, especially in areas such as insurance and employment. That does not mean, however, that its *juries* are favorable to business. So a business can eat its cake and have it too, by not designating the New York courts as a forum -- or by designating another forum -- but requiring the application of New York law to interpreting the contract.

On the other hand, going back to brokerage contracts, the application of New York law could be detrimental to a consumer. Most states have **blue sky laws**, which to the extent not pre-empted by federal law add some additional requirements and often more effective remedies to the federal system of securities regulation. New York, which is home to most of the brokerages, doesn=t; it only has an anti-fraud law. A New York choice-of-law clause could pull your state=s more protective blue sky laws out from under you.

Some courts have balked at applying choice-of-law clauses in consumer contracts. They reason that a company should not be able to escape the consumer-protection laws of its customer=s home state with such a clause. If that were allowed, eventually those laws would be rendered less meaningful. Thus they hold that, as a matter of policy, such clauses will not be enforced where they deprive consumers of the protection of their state=s consumer-protection scheme. Some state laws dictate this result. Other courts, however, take a more Atraditional@ approach. If there is no evidence of fraud or abuse of bargaining power, they will enforce the clause. Again, if your bargaining position is such that you can=t

get away from this clause, or you don=t know if you would want to, only a lawyer is qualified to advise you of your options.

WAIVERS IN GENERAL

A waiver, as we said above, is the voluntary relinquishment of a known right. By Avoluntary,@ the law does not mean you necessarily *wanted* to give the right up, but rather that you were *willing* to give it up in order to make the deal happen. In that sense, a waiver of a right is merely a type of consideration, little different from money. You don=t, in an absolute sense, really *want* to give up your Edsel, but for $1500, you=re *willing* to do it.

We have been talking about waiver clauses in contracts, which are a kind of **express waiver**. An express waiver is a written or oral statement that the party is willing to forego a right he or she has. Some consumer contracts provide, however, that no waiver of any of the contract terms will be effective unless done in writing. This is not an evil provision, but it means that any oral promises concerning one party=s right to enforce a specific contract provision are unenforceable.

Even then, however, there are courts that will, given the totality of the circumstances, decide that the Ano oral waiver@ clause *itself* was waived! The most common example of this is where a homeowner tells a contractor to do additional work not covered in the contract. The contractor goes ahead with the work, but the homeowner refuses to pay, pointing to the Achanges in writing only@ clause. Most courts will say that, by authorizing the work and watching as it is done, the homeowner has waived the right to rely on that clause.

In the last example, watching the work as it is done, without protest, is called an **implied**

waiver. That means that one party=s behavior is Aas good as@ an explicit statement that he or she does not intend to enforce a certain condition or requirement of the contract. For example, let=s say you rent an apartment under a lease that requires payment of rent by the first of each month. One month, you forget to pay on time, but send the check a week later in the hope that the landlord will accept it, which happens. In doing so, the landlord has implicitly waived the right to evict you for failing to live up to the contract. The landlord cannot, after accepting the check, get you evicted for violating the lease. (Most leases and state laws are not this simple, but we will discuss this more in chapter 7.) That is an implied waiver. Alternatively, if you wrote and asked the landlord to take the check, and the landlord wrote back saying that he or she was willing to give you a break this time only, it would be an express waiver limited to the one late payment.

Many contract forms have another kind of Anon-waiver@ clause that says that, even if, as in the above example, the landlord accepts late payment once, the landlord has not waived the timely-payment requirement for all time. That means the landlord could insist on strict adherence to the contract terms next month, even after letting you slide this month. This is a fundamentally fair clause, and may actually result in a looser, more forgiving relationship between the parties. They don=t need to fear that giving the other guy a break from time to time will alter their long-term expectations under the contract. But it does mean that you shouldn=t get into the habit of paying late, because any time -- the second or the 14th time -- you miss the contract deadline, the landlord could claim you are in breach of the lease. However, that pattern could lead a court to say you were entitled to notice of a return to strict enforcement before breach is claimed. As soon as the landlord claims a breach, you should consult a lawyer.

What other waivers do form contracts frequently contain? Here are a few common ones:

! **Consequential damages.** Consequential damages, as will be discussed more in chapter 15, are compensation for the harm that a person suffers as a consequence of the actual wrong done. The best example is where you lose your term paper because your computer blows up. The warranty (a part of the sales contract, as discussed in chapter 8) will invariably state that consequential damages are not covered by the manufacturer. They may repair your computer, or even give you a new one, but under the contract they will not write your term paper for you, or compensate you for the time you'll have to spend recreating it. Most states will uphold limitations such as these, though compensation for other consequences -- such as personal injury as a result of a malfunction -- may be available under contract or tort law or notwithstanding the purported limitation as a matter of public policy. The idea behind these clauses is that the seller cannot know what use you intend to make of its product, nor the extent to which you take your own precautions. After all, considering all the things that can go wrong with a computer, if you don't back up your data on a regular basis you have only yourself to blame.

! **Punitive damages.** These are also discussed more fully in chapter 15. But a waiver of the right to claim punitive damages is a variation on the waiver of consequential damages. Some states will not enforce these waivers, regardless of the circumstances of the contract. The reasoning is that punitive damages cannot be waived as a matter of public policy.

! **Defenses.** It is common, especially in consumer credit contracts, for certain legal defenses -- some of which we discussed in chapter 3, and some other, more obscure ones -- to be waived by the consumer. The enforceability of these clauses frequently depends on the state

you=re in and the overall situation of the contract. But you certainly would want to beware of a contract that takes important contract defenses out of your hands before you even start the relationship.

! **Jury trial.** This is one of the most common waivers found in contracts used by large businesses. They know that juries often start out more sympathetic to the Alittle guy.@ Jury trials are also more expensive, complicated and time-consuming than trials where a judge makes both the legal and factual decisions. For that reason, if you decided to sue, you might choose not to have a jury anyway. On the other hand, if there is a lot at stake, you may not want to give up this constitutional right usually guaranteed by the Constitution. (Cases where little money is at stake are often heard in small claims court, where jury trials are not available.)

! **Attorneys= fees and legal costs.** Many contracts, especially mortgages and other extensions of credit, require the borrower to pay any attorneys fees and other legal costs (e.g., filing fees and other costs of litigation) incurred by the creditor in its efforts to collect money owed on the contract. This is usually an enforceable clause, and in itself can amount to a substantial penalty on a party that breaches a contract.

As we said above, there are as many possible things to waive as there are rights of parties in a contract. Certainly, there is no reason for you to agree to, say, an attorneys= fees clause in a contract to sell your Edsel, paint your house, or provide oboe lessons. But in many of the above cases we've discussed, you may have no negotiating power. Then you have to choose how valuable the right that the contract wants you to waive is, compared to what you stand to gain by negotiating it away, or walking away from the whole deal. In other words, waivers are just like any other contract provision.

SECURITY INTERESTS

Jerome thought he was only having his kitchen rebuilt. The price seemed right, and the contractor was prepared to finance the work too, so he could avoid dealing with bankers. When the steel sink turned a greenish grey, however, he was disappointed. When the contractor refused to return his calls, he was angry. When Jerome stopped making payments, he was smugly satisfied. When he got a notice of foreclosure -- he was more than a little shocked.

In the above example (which admittedly is a little extreme), Jerome didn=t appreciate the fact that his financing agreement for the kitchen remodeling included a mortgage. Perhaps he should have, since both federal and some state laws provide disclosure about this, but many consumers ignore this information. Under that document, he made his house **collateral**, for payment of the contract. A consumer's breach of a contract that includes a mortgage or a **security interest** allows the creditor to Aturn to@ the collateral to make sure the money is paid. ATurn to@ means Atake it and sell it.@ Even without foreclosing, as long as someone holds a security interest, or **lien**, in your home, you will be unable to pass on clear title -- that is, you will have a hard time selling it.

Is it worth risking your house for new kitchen cabinets? Maybe. Analyzing that risk is up to you. It may be a better deal for you to get a home-equity line of credit from a bank to pay for the repairs rather than financing through the contractor, though beware of overspending if you have an equity line of credit that gives you checks and easy access to your home's equity. Look out for security-interest clauses in consumer credit contracts, so you=ll at least have the chance to do your analysis before you=re bound by contract. In this example, federal and some state laws may give you a right to rethink and

cancel the deal, but not every transaction carries that right.

COSTS AND FEES

The most fundamental contract terms, of course, are the ones that tell you what the thing you're bargaining for is going to cost you. But beware of terms that subtly change the economic formula behind your back, and give away what you worked so hard for in negotiating the fundamental deal. Even if the "deal" is one where you have had little to negotiate about -- say an agreement to open a credit line, or some other kind of "take it or leave it" transaction -- you must find, read and understand these clauses to determine whether you can afford the transaction at all.

Typical fees of this type include:

- high "deductibles" in appliance service contracts, which often negate their practical value;
- service charges on checking and savings accounts, including fees for returned checks of $10 or more -- meaning that even a temporary inability to cover your checks could cost you big dollars in returned-check fees;
- credit insurance, very costly decreasing term life insurance to cover the amount of credit you're getting;

The possibilities are endless. Other kinds of costs that consumers should be aware of will be discussed in the related chapters later in the book. But the idea, again, is that it does pay to read the whole contract, and see what a transaction will really cost before you sign up.

Click here to go to Chapter 5