

**MAJOR LENDERS MAY VIOLATE DUE PROCESS
BY ENFORCING ONE-SIDED ARBITRATION CONTRACTS
TO AVOID BORROWERS' DEFENSES TO FORECLOSURE**

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ARTICLE SUMMARY: Many major, contemporary players in the huge sub-prime U.S. mortgage lending market require their borrowers to execute loan agreement riders requiring arbitration of all disputes with regard to the loan transaction, but with the significant exception of the lender's right to foreclose. While such agreements have frequently been challenged on unconscionability grounds, enforcement of the *ex parte* aspects of such contracts also raises concerns about compliance with procedural aspects of the Due Process Clause, when either lender enforcement of the loan agreement itself or foreclosure is sought through the courts. Foreclosure normally occurs more promptly than arbitration, and borrowers may be unable to raise significant defenses during foreclosure, whenever the agreement requires all defenses be adjudicated in the more leisurely arbitration proceeding. Court enforcement of such non-reciprocal riders may risk an erroneous deprivation of a borrower's substantial property interest.

Introduction.

Courts generally reject *ex parte* court procedures where one party has an opportunity to have its claims adjudicated, while the opposing party's ability to litigate related claims and defenses is blocked. This article examines whether enforcement of commonly used arbitration riders to mortgage loan contracts may run afoul of the Due Process Clause when such riders allow foreclosures to proceed free of challenge by the borrowers, all of whose defenses must go to arbitration.

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As an example, the author was asked to represent in his law school clinic a poorly educated, low income, minority homeowner, call her “Ellen Homeowner”. She was facing foreclosure on her home, which she had inherited two years earlier from her mother. The home was encumbered by a mortgage from a major, nationally active, sub-prime lending company: call the company “Sub-Primer”. Ms. Homeowner had fallen several months behind in her loan payments, which called for a high percentage of her monthly income. Non-judicial foreclosure was threatened in a letter from the Sub-Primer. Ms. Homeowner filed suit against Sub-Primer alleging two claims. First, the lender lacked a license to engage in mortgage lending as required by state law. Second, the Sub-Primer failed to get the current homeowner’s signature on any loan documents at the same time it made the loan to her mother. Under D.C. law, there is a strong claim that the lender’s lien on the home had expired upon the death of the borrower’s mother², and a claim that the loan was void for having been made without a license³.

Sub-Primer promptly filed a motion in Ms. Homeowner’s suit asking the court to stay all proceedings against it pending an arbitration of her claims. Ms. Homeowner’s mother had signed a rider to the loan agreement when she originally took out the loan. The rider required “both parties” to arbitrate “all issues”, claims, and defenses pertaining to the loan.⁴ However, the

² E.g., *Gallimore v. Washington, et al.*, 666 A.2d 1200, 1203-04 (D.C. 1995)

³ D.C. Code §26-1103(2001(ed.)).

⁴ In bold type the rider stated: **THE PARTIES ACKNOWLEDGE THAT THEY HAD A RIGHT TO LITIGATE CLAIMS THROUGH A COURT BEFORE A JUDGE OR JURY, BUT WILL NOT HAVE THAT RIGHT IF EITHER PARTY ELECTS ARBITRATION. THE PARTIES HEREBY KNOWINGLY AND VOLUNTARILY WAIVE THEIR RIGHTS TO LITIGATE SUCH CLAIMS IN A COURT BEFORE A JUDGE OR JURY UPON ELECTION OF ARBITRATION BY EITHER PARTY.**

The fine print of the rider provides in part that: “By signing this Arbitration Rider, you agree that either Lender or you may request that any claim, dispute, or controversy (whether based upon contract, tort, intentional or otherwise; constitution; statute; common law; or equity

rider contained an exception to the “all issues” provision, and that exception allowed “any party” to seek “preliminary or ancillary remedies”, including “foreclosure”. In other words, the lender wrote the rider in such a way to exclude from arbitration its claims of rights to foreclose on the property, i.e., to proceed directly to foreclose on the property in the event of default by the borrower. Foreclosure would likely have ended the homeowner’s interest in the property well before her claims could be heard in an arbitration proceeding⁵. The court granted Ms. Homeowner a preliminary injunction, based on a variety of factors, against the foreclosure pending the outcome of the rest of the litigation.

Foreclosure processes differ from state to state. In states and jurisdictions allowing non-judicial foreclosure through, for example, a power of sale the lender would ordinarily send written notification to an allegedly defaulting borrower that a foreclosure would take place within a statutorily prescribed time period, often 30 days.⁶ If the borrower did not cure the default, the

and whether pre-existing, present or future), including initial claims, counter-claims, and third party claims, arising from or relating to this Agreement or the relationships which result from this Agreement, including the validity or enforceability of this arbitration clause, any part thereof or the entire Agreement (“Claim”), shall be resolved, upon the election of you or us, by binding arbitration pursuant to this arbitration provision and the applicable rules or procedures of the arbitration administrator selected at the time the Claim is file....”.

⁵ The exclusion of the remedy of foreclosure or repossession from the general arbitration of issues between the parties is widely used. Similar provisions allowing for *ex parte* foreclosures or repossessions in their loan agreements are used by, among many others, AAMES Home Loan, CitiFinancial Mortgage, Conseco Bank, and Household Finance. Samples are compiled in PAUL BLAND, JR., MICHAEL J. QUIRK, KATE GORDAN, JONATHAN SHELDON, CONSUMER ARBITRATION AGREEMENTS, ENFORCEABILITY AND OTHER TOPICS, National Consumer Law Center Credit and Sales Legal Practice Series. Fourth Ed., 2004. (“Bland” hereinafter). Appendices (CD-ROM).

⁶ *E.g.* D.C. Code §42-816 (2001 ed.)(all citations to the D.C. Code are to the 2001 ed.).

lender would then sell the property at a public auction to a third party purchaser. The third party purchaser could then proceed to court to evict the borrower under state forcible entry and detainer laws.⁷

Would a judicial foreclosure comport with Due Process in this or similar cases? Would the court be required by Due Process to eschew granting a stay of the litigation in favor of arbitration unless the lender agreed to having its foreclosure claim heard collectively in the same forum with the borrower's claims and defenses?

The lender in the example makes a high number of loans across the country, and uses this same form arbitration rider with most of its loans. Many sub-prime mortgage lenders and other consumer lenders have turned in recent years to the practice of asking borrowers to sign arbitration riders when entering into consumer loan transactions, particularly sub-prime loans.⁸ Arbitration riders are used as a deterrent to class action litigation which seeks to enforce various forms of consumer protection legislation.⁹ Specific arbitration riders have been rejected by courts in many cases as unconscionable, against public policy, or for other reasons.¹⁰ Most challenges to arbitration agreements in the consumer area have been based on their unconscionability. Other courts have upheld the riders because they implement a strong and long-

⁷ For example, in the District of Columbia, D.C. Code § 16-1501 (2001 ed.).

⁸ BLAND, P. 4.

⁹ Id. 47 - 86.

¹⁰ See, e.g., *Luna v. Household Finance Corporation III*, 236 F. Supp. 2d 1166 (W.D. Wa. 2002); *ACORN, et al. v Household International et al*, 211 F. Supp. 2d 1160 (N.D. Ca. 2002).

lasting federal policy favoring arbitration as expressed in the Federal Arbitration Act (“FAA”).¹¹

This article examines whether use of an arbitration rider which on its face permits the lender to proceed to foreclosure on its lien, while all the borrower’s counterclaims and defenses are stayed pending arbitration, comports with the standards of the Due Process Clause.¹² This Due Process analysis has not been used in consumer challenges to arbitration agreements.¹³ In the example, cited above, the lender did consent to staying foreclosure at an early stage of the litigation filed by Ms. Homeowner when confronted with this issue, *inter alia*, before the court, and consented to having the borrower raise as a defense in the foreclosure proceeding any of the borrower’s claims and defenses without having to first arbitrate their validity. The lender did not, however, take steps to modify the form of the rider for all its borrowers or to inform other borrowers of this modified position.

Part I sets forth the familiar three part test for state court procedure compliance with federal Due Process under relevant Supreme Court law, examines whether the lack of reciprocity

¹¹ 9 U.S.C. § 1, *et seq.* *Miller v. Flume*, 139 F.3d 1130, 1136 (7th Cir. 1998)(“...’once it is clear the parties have a contract that provides for arbitration of some issues between them, any doubts concerning the scope of the arbitration clause should be resolved in favor of arbitration.”) . *Moses H. Cone Mem. Hosp. v. Mercury Constr. Corp.*, 460 U.S. 1, 24-5, 74 L. Ed. 2d 765, 103 S. Ct. 927 (1983).” *McIntyre, v. Household Bank*, 216 F. Supp. 2d 719, 722 (N.D. Ill. 2002) (granting stay of Truth In Lending Act court claim under credit card arbitration contract).

¹² Some courts have held that this lack of mutuality of legal remedies contributes to a finding that an arbitration contract is substantively unconscionable, without reaching the due process issue. E.g., *Dunlap v. Berger*, 567 S.E.2d 265 (W. Va. 2002)(rejecting arbitration provision retaining significant rights to use the court system for a consumer lender, but denying access to the court system to a borrower); *Arnold v. United Companies Lending Corp.*, 511 S.E. 2d 854 (W. Va. 1998)(same).

¹³ The author has found no reported cases where the Due Process analysis developed in this article has been applied.

in a contractual arbitration agreement meets that test in mortgage foreclosure settings, and considers the effect of a borrower's consent to arbitration on due process rights. Part II examines whether provisions of the Federal Arbitration Act may obviate any due process concerns in these situations. Part III examines what procedures courts might follow to respond to due process considerations raised by these riders, and what legislative remedies there might be.

PART I

RECIPROCITY AND PROCEDURAL DUE PROCESS

The Due Process Clause requires certain minimum standards for private parties' use of the court system to obtain remedies, including judgments, for contract, tort, and other claims. The Supreme Court has derived a three part test for measuring a court's handling of such private claims, namely, the nature and significance of the private interest at stake, the risk of erroneous deprivation of that interest under the procedures used, and the costs to the government to implement procedures that would reduce the risk of erroneous deprivation. Attention must be paid to the effect on the opposing party's interests of procedures used.

In *Connecticut v Doehr*,¹⁴ the Supreme Court applied this three part test and reviewed a challenge to a state court procedure which allowed pre-judgment attachment of an alleged tortfeasor defendants' property by the simple filing of an affidavit by the plaintiff-tort victim. The Court followed the line of analysis set forth in the seminal decisions under *Mullane v Central Hanover Trust*,¹⁵ *Fuentes v Shevin*,¹⁶ and *Mathews v Eldridge*¹⁷. Connecticut's procedures were

¹⁴ 501 U.S. 1; 111 S. Ct. 2105; 115 L. Ed. 2d 1(1991).

¹⁵ 339 U.S. 306, 70 S. Ct. 652, 94 L. Ed. 865 (1950).

held violative of Due Process because of the high risk of erroneous deprivation that might occur if, for example, the plaintiff in the case filed a false or misleading affidavit, and other factors.¹⁸

The Supreme Court was unwilling to countenance an *ex parte* state court proceeding to deprive a party of its interests on the basis of one party's mere filing of statements by the plaintiff before any fair adjudication of both sides' interests could occur.¹⁹ There was no issue in *Doehr* of the defendant having consented in any way to the use of the procedures.

A. The Three Part Test.

The Supreme Court had earlier held in a number of contexts that *ex parte* proceedings may violate Due Process, depending on a number of factors.²⁰ In these decisions, the Court expressed an unwillingness to allow a party making a claim to gain access to substantial relief from a court without the defendant having a fair chance to offer a defense to the claim.

¹⁶ 407 U.S. 67 (1972).

¹⁷ 424 U.S. 319; 96 S. Ct. 893; 47 L. Ed. 2d 18 (1976).

¹⁸ The author has derived a similar analysis of the rule of the District of Columbia Landlord and Tenant Branch of Superior Court limiting counterclaims by tenant defendants in Forcible Entry and Detainer Actions. Lynn E. Cunningham, *Procedural Due Process Aspects of District of Columbia Eviction Procedures*, RUTGERS RACE AND THE LAW REVIEW (forthcoming, Spring, 2005).

¹⁹ 501 U.S. at 12.

²⁰ *Fuentes v. Shevin*, 407 U.S. 67 (1972)(rejecting writ of replevin of personalty based merely upon *ex parte* application by the plaintiff seeking replevin; rejecting summary extra-judicial process of pre-judgment seizure); *Lynch v. Household Finance Corp. et Al.*, 405 U.S. 538 (1972) (allowed due process challenge to state court pre-judgment garnishment procedures against a consumer); *Sniadach v. Family Finance Corp. of Bay View, et al.*, 395 U.S. 337 (1969)(reviewing due. process compliance of summary pre-judgment remedies; seizure occurred prior to debtor having any opportunity to contest).

Since the Supreme Court's decision in *Doehr* in 1991, many lower courts have continued to reject *ex parte* state court proceedings resulting in the taking of another party's property or interests.²¹ One recent example, in *Landers v. Jameson*²² the Arkansas Supreme Court applied *Doehr* to a challenge to an Arkansas statute which had allowed owners of stolen property to reclaim the property from a pawn broker simply by requesting it from the pawn broker and by filing an affidavit with the court stating that they owned the property. The Arkansas court found that the risk of erroneous deprivation was substantial. The pawn broker was forced to file suit to have the true ownership of the property determined and to incur substantial expenses, all to respond to a bare claim to the property made by the alleged owner. The procedure rejected by the court in *Landers* bears striking similarity to the situation where a mortgage lender can, simply by filing a motion to stay in a suit by the borrower, in favor of a confidential, and expensive arbitration proceeding, postpone any hearing on every counter-claim and defense by the borrower to foreclosure. The lender may proceed to foreclosure on the property, free from facing any defenses by the borrower.

State action is a necessary element of any claim to protection under the Due Process Clause, and state action will be present in situations where court enforcement of the arbitration

²¹ See, e.g., *Keystone Builders, Inc., v. Floor Fashions of Virginia, Inc., et al*, 829 F. Supp. 181(1993) (reviewing compliance of Virginia state court pre-judgment attachment procedures with *Doehr* standard). *Pawnbrokers & Secondhand Dealers Ass'n, Inc. v. City of Fort Lauderdale*, 699 F. Supp. 888 (S.D. Fla. 1988) (police seizure of property in possession of a pawnbroker without notice and a hearing violated due process). See also, *American Surety Co. v. Baldwin*, 287 U.S. 156, 168 (1932) ("Due process requires that there be an opportunity to present every available defense.").

²² 2003 Ark. LEXIS 649 (Ark Ct App. 2003)

riders is sought by the lender.²³ Far from always being simple private contracts devoid of state action, the arbitration riders are sheltered under the FAA, which, lenders argue, empowers courts to enforce arbitration of a wide variety of federal and state procedural laws. Thus, state action is found in this combination of use of the courts to enforce the rider, followed by the ability of the winner of the arbitration to enforce an arbitration award in court, and, finally, by the ability of the lender to enforce foreclosure in court under some the laws of some. Lenders seek to stay litigation by their borrowers in favor of arbitration precisely because at the end of arbitration the lenders intend to return to court to enter a judgment under the arbitration, having bypassed many of the usual protections of court process, including the right to have an appeal to review the decision of the trial court.²⁴ On the other hand, state action may not be present if the borrower files no claims against the lender in a court and if a lender does not involve the arbitration rider

²³ Normally the sub-prime lender will seek the protection of any court where the borrower may have filed claims seeking to stop the foreclosure, or the lender may file its own suit to compel arbitration if the borrower fails to cooperate with the arbitration. Lenders and other arbitration rider users are generally entitled to a stay of all court proceedings in favor of arbitration under the FAA. The FAA creates a robust federal law context for the stay of judicial consideration of many kinds of borrowers' claims pending the outcome of arbitration. Federal claims were stayed in cases such as: *Green Tree Financial Corp.-Alabama and Green Tree Financial Corporation v. Randolph*, 531 U.S. 79 (2000) (TILA claims subject to arbitration under FAA); *Equal Employment Opportunity Commission v. Waffle House, Inc.*, 534 U.S. 279 (2002) (EEOA claims subject to arbitration under FAA); *Clinton Cole v. Burns International Security Services*, 105 F.3d 1465 (D.C. Cir. 1997) (same). State consumer legislation claims were stayed in several cases, such as: *Bess v. Check Express*, 294 F.3d 1298 (11th Cir. 2002); *Snowden v. Checkpoint Check Cashing*, 290 F.3d 631 (4th Cir. 2002); *Burden v. Check into Cash of Ky., LLC.*, 267 F.3d 483 (6th Cir. 2001).

²⁴ Other normal in-court protections missing in the AR include the right to a jury trial, the right to full pre-trial discovery, the right to join a wide variety of claims and defenses, and to have them all heard in one proceeding.

in the foreclosure, as for example, when a power of sale is used.²⁵

This gutting of fair court procedures by means of arbitration closely parallels the shortcuts to resolution of disputes rejected in *Fuentes*, *Doehr*, *Landers*, and other cases as being violative of Due Process. Such court involvement in generating what is ultimately a court judgment based on the arbitration²⁶ is sufficient to give rise to “state action” upon which to ground the Due Process claim here.

How precisely do such non-reciprocal arbitration riders run afoul of the these Due Process principles? To the extent they do, when, and under what conditions may a party contract away its right to defend itself in a foreclosure proceeding, as the rider apparently provides? These questions are addressed in the following two subsections.

B. NON-RECIPROCAL ARBITRATION AGREEMENTS AND DUE PROCESS.

But for the issue of borrower’s purported consent, lender’s use of a contractual provision to enable it to proceed to foreclosure without timely court consideration of a borrower’s counterclaims and defenses, seems squarely afoul of the *Doehr* three part test.

Under the first part of the test, both parties to the foreclosure proceeding have substantial

²⁵ *E.g.*, *Bryant v. Jefferson Federal Savings and Loan*, 509 F.2d 511 (D.C. Cir. 1974)(foreclosure by means of a power of sale provided in the loan agreement does not implicate due process protections because of lack of state involvement.) *See also*, *Flagg Bros. v. Brooks*, 436 U.S. 149 (1978)(warehouseman’s power of sale did not implicate due process because of lack of state involvement). In other words, the mere presence in the loan agreement of a provision permitting the borrower to conduct an *ex parte* power of sale, does not by itself likely give rise to any due process violation because there is no state involvement in the foreclosure by power of sale.

²⁶ The AR used as an example in this article provides explicitly as follows:

interests, worthy of due process protection. The lender has often lent the borrower substantial sums of money. In the case used as an example discussed at the beginning above, the loan amounted to over \$100,000. It should be noted that the lender faces a reduced risk in home mortgage cases of a house losing value during arbitration or litigation. Hence a stay of foreclosure pending resolution of the borrower's defenses normally causes relatively little risk of loss to the lender. If an arbitration can be accomplished in a matter of months, the delay of a foreclosure is of minor interest to a major lender, whose interest on its loan will continue to accrue during the arbitration period. Nevertheless, the lender's interests are substantial and worthy of protection under due process.

The borrower in turn stands to lose her personal residence, her home, and to face a serious loss of her ability to shelter herself and her family comfortably. The substantiality of these interests would seem to call for procedures that should result in no more than a small or very modest risk of erroneous deprivation.

The risk of erroneous deprivation of borrower's property is unacceptably high in a foreclosure procedure where the borrower's defenses can not be brought to bear in response to the lender's claim for foreclosure until well after the foreclosure has occurred and the house sold to a third party. When the lender comes forward with what appears to be a substantial claim of a right to foreclose, usually based on the borrower's default in payment, the borrower may in fact have substantial defenses and counterclaims. These may include: proof of actual payment of the allegedly past due mortgage payments; lender miscalculation of the amounts paid or owing;

“Judgment upon the award may be entered in any court having jurisdiction.”

claims against the lender under the Truth In Lending Act²⁷, Home Ownership and Equity Protection Act of 1994²⁸, and state consumer protection legislation against some lenders, and even fraud by the lender.²⁹ The foreclosure that proceeds to sale of the borrower's house before these claims can be adjudicated by the arbitrator may easily result in the irrevocable loss of the borrower's home, as well as her equity in the home, even if she later obtains an arbitration award for some amount of money from the lenders based on these claims. There may be defects in the foreclosure notice and proceeding itself which, if the borrower could timely raise them, would delay or temporarily defeat a proceeding. Yet these defects under a plain reading of the rider would be required to go to arbitration.

The dual nature of the adjudication process inevitably involves the *Doehr* analysis, because the foreclosure in these situations is, under the rider's terms, not an arbitration matter, where the lender's relief is obtained before the opposing party's response can be raised and considered by any adjudicative procedure. In this sense, this approach to foreclosure more closely resembles the Connecticut state court procedure rejected in *Doehr*, since the lender need only file for foreclosure, without any consent to the foreclosure or any ability to respond to the foreclosure by the borrower. Thus, there is a strong basis for saying that the dual process, entailing *ex parte* litigation by the lender is so inherently fraught with the risk of erroneous action as to lie outside the boundary of process that is due.

²⁷ 15 U.S.C. §§1601-1666j.

²⁸ 15 U.S.C. §1639.

²⁹ E.g. *Green Tree Financial Corp.-Alabama and Green Tree Financial Corporation v. Larketta Randolph*, 531 U.S. 79 (2000) (TILA claims subject to arbitration under FAA).

Hence, the issues with *ex parte* proceedings raised in *Fuentes v Shevin*, *Doehr*, and the other cases discussed above, would be present if any court allowed a foreclosure to proceed without a timely opportunity for a defense by the borrower to ward off the irreparable loss of her home. Courts are not likely to countenance such a bifurcation, precisely because of the due process implications raised. Hence, at a minimum, a borrower who files suit against a lender to stop a foreclosure should be able to win a court stay of the foreclosure, even if her claims are stayed pending an arbitration.

The lender's best response, therefore, is to point out that the borrower "consented" to waive any right to defend herself in the foreclosure proceeding by signing off on the arbitration rider.

C. BORROWERS' CONTRACTUAL WAIVER OF DUE PROCESS

Waiver of a party's procedural due process rights generally must be "knowing, intelligent, and voluntary."³⁰ The parties to a rider must be shown to have met this standard, and if it is not, the waiver is held to be invalid.

In the consumer protection context this issue of waiver has been litigated in connection with consumers' waivers of their rights to a jury trial on their claims. Numerous cases have rejected agreements to arbitrate which waived the right to a jury trial on this basis.³¹ Others have upheld such waivers.³² An agreement to allow the lender *ex parte* access to the court should be

³⁰ *D.H. Overmeyer v. Frick*, 405 U.S. 174 (1972). See, Bland, *supra*, §3.5.1 *et seq.*

³¹ *Ibid.*

³² *Ibid.*

subject to at a minimum the same analysis as waiver of the right to a jury trial.

However, waiver of procedural due process in this context should be scrutinized more carefully than waiver of right to trial by jury. First, federal constitutional law is implicated, rather than state law on waive, since in most jurisdictions, the right to a jury trial is based on state law, not federal constitutional law. If right to a jury trial is based on state law, then the waiver of that right may be based on state law, and may vary from state to state. Second, when a party agrees to arbitrate a case, by definition the contract calls for a trier of fact which is an arbitrator rather than a jury. Hence, it is somewhat more difficult to make out a case that the waiver was not in some sense “knowing”: the borrower at least knew that someone other than a jury would be making the award. Attacks on waivers of jury trials have focused on proving that the consumer’s consent to the rider itself was not knowing, intelligent, and voluntary, or on even some lesser standard under state law waiver doctrines.

A borrower agreeing in a consumer lending contract to allow the lender to have *ex parte* access to the court system for the purpose of foreclosure raises thornier issues than waiver of right to a jury trial. Here the fundamental issue to which any court must be sensitive, under the *Doehr* holding, is the degree of risk of erroneous deprivation by the full sequence of procedures applied to the case. The parties after all are not waiving all court action, but only the adjudication phase, i.e., replacing a court decision with regard to the merits of the case by the use of an arbitrator. Hence, neither party is waiving access to the court at some stage of the process, only at the adjudication phase. In a jury trial waiver, once a party has waived that right, there are no further issues with regard to involvement by a jury. On the other hand, court process is involved at significant steps in the case entailing an arbitration phase, especially at the point of

entering a judgment on the award. Hence, the applicability of the *Doehr* analysis to each phase of the litigation involving an arbitration is not waived in a rider purportedly consenting to arbitration of the merits phase of an adjudication.

In *D.H. Overmyer v. Frick*,³³ the Court examined the due process implications of two commercial parties' use of a "cognovit note" procedure, where one party authorizes the other to enter consent judgment against it upon default in a contract. The Court found no due process violation under the procedure where the state law governing the use of such notes permitted the defaulting party to have a court hearing to determine whether to set aside the consent judgment upon a showing by the defaulting party of a valid defense to the original breach of contract claim.³⁴ The defaulting party, against whom a judgment was entered by consent, has a right to a hearing on whether it had a valid defense, according to the Court. Under the *ex parte* arbitration rider, the defaulting borrower might never have an opportunity for her claims to be heard before losing her house, unless the court overseeing enforcement of the arbitration agreement takes certain actions to make certain the borrower obtains a timely determination of her claims and defenses. For example, the court staying the borrower's suit in favor of arbitration might also stay the foreclosure pending the outcome of the arbitration. Alternatively, in a judicial foreclosure, the court entertaining the foreclosure claim might handle the borrower's claims as defenses to the foreclosure, and disregard any insistence by the lender that such defenses had to go to arbitration alone. A court faced with enforcing a foreclosure should have to determine

³³ *Supra.*, footnote 28.

³⁴ The Court determined that different states had differing standards for what constituted a valid defense to the breach of contract claim, and what level of proof was needed to establish a defense. 405 at 187.

whether the borrower had had a fair opportunity of presenting her defenses to the foreclosure before the foreclosure proceeded. For example, if the court stayed the foreclosure pending the outcome of the arbitration, and the arbitration award has the potential for preventing the foreclosure, the due process concern would likely be resolved since the borrower would have had a fair opportunity to have her claims and defenses heard through the arbitration.³⁵

Even when the parties have consented to the procedures, a court asked to determine whether to stay a borrower's court litigation of claims in favor of arbitration should carefully examine the validity of the borrower's claims to determine whether they might have the effect of preventing the foreclosure, the validity of the foreclosure claim, and then, whether the borrower has waived her court protections at every phase of the litigation voluntarily, knowingly, and intelligently.

The analysis plays out is somewhat differently if both parties have consented to an arbitration process that is fully mutual, i.e., covers all aspects of the foreclosure as well.³⁶ If the validity of the foreclosure claim will be determined in the same arbitration with the borrowers claims and defenses, the concern here about *ex parte* proceedings would seem to be attenuated. The court should still determine whether each side's consent is knowing, intelligent and voluntary. However, likely neither party can later challenge an award in that arbitration on the basis that the proceedings lacked due process.

In conclusion on Part I, the literal enforcement of an arbitration rider that purports to

³⁵ As noted, in a power of sale foreclosure, where no court is involved, the due process concerns with the *ex parte* arbitration rider would apparently remain dormant..

³⁶ The author has not located an example of an arbitration rider in the mortgage lending business where such mutuality exists.

authorize the lender to engage in *ex parte* foreclosure would seem to be unconstitutional under the *Doehr* standard because it inevitably entails an unacceptably high risk of erroneous deprivation of the borrower's property. Courts when they are asked to enforce an arbitration rider should apply a full and thorough *Doehr* analysis of such procedures prior to any foreclosure to comply with the court's constitutional duty to see that proceedings before it comport with due process.

PART II

THE FEDERAL ARBITRATION ACT'S ROLE IN PRESERVING DUE PROCESS PROTECTIONS FOR BORROWERS

Consideration should be given to whether the provisions of the FAA itself might obviate these due process concerns. In short, they do not. Indeed, use of the FAA to gain enforcement of the literal terms of an *ex parte* rider would allow the dominant party in a commercial relationship to block the subsidiary party from arbitrating its defenses to enforcement of the dominant party's claims. This would seem to stand the FAA on its head, and be contrary to the intent of the statute to encourage arbitration.

The FAA does provide limited opportunities to parties to arbitration contracts to challenge the fairness of the arbitration procedure in some manner.

First, section 2 provides that whenever an action is brought in federal court to resolve a dispute arising under a contract, and the contract contains a provision requiring arbitration, the court "shall" stay the court action, in favor of allowing the arbitration to proceed.³⁷ But this is

³⁷ "§ 2. Validity, irrevocability, and enforcement of agreements to arbitrate

limited by the proviso that the underlying contract must itself be “valid, irrevocable, and enforceable”. In response to this proviso, courts have developed lines of analysis as to when to permit a matter to proceed to arbitration, depending on the validity of the underlying contract and of the agreement to arbitrate itself.³⁸ But this important protection hardly obviates the due process concerns raised here. Indeed, while the borrower is litigating in court the validity *vel non* of the arbitration rider, or the underlying contract, or the enforceability of the rider, the lender might well be proceeding with its foreclosure. The borrower should clearly ask the court stay the foreclosure with a preliminary injunction. But the *ex parte* nature of the arbitration agreement places the lender in the position to argue that the borrowers’ claims must be stayed in the court, while no such barrier exists for the foreclosure. Section 2 of the FAA can be read to say that a rider with the *ex parte* provision lacks “enforceability”, but the term may be too vague, and hence require legislative clarification if it is to protect borrowers’ interests.

Section 3, provides that a party to an arbitration contract may be compelled to arbitrate a

A written provision in any maritime transaction or a contract evidencing a transaction involving commerce to settle by arbitration a controversy thereafter arising out of such contract or transaction, or the refusal to perform the whole or any part thereof, or an agreement in writing to submit to arbitration an existing controversy arising out of such a contract, transaction, or refusal, shall be valid, irrevocable, and enforceable, save upon such grounds as exist at law or in equity for the revocation of any contract.”

³⁸ See e.g., *Prima Paint Corp. v. Flood & Conklin Mfg. Co.*, 388 U.S. 395 (1967); *Weis Builders, Inc. v. Kay S. Brown Living Trust*, 236 F.Supp.2d 1197, 1204 (D.Colo., 2002) (arbitration of construction contract stayed pending determination of whether the main contract was void because procured by fraud). For a discussion of the Supreme Court’s approaches to the separability doctrine, see, Richard Reuben, *First Options, Consent to Arbitration, and the Demise of Separability: Restoring Access to Justice for Contracts with Arbitration Provisions*, 56 SMU L. REV. 819 (Spring, 2003).

dispute by the opposing party filing suit in federal court and requesting such relief.³⁹ State courts may also render such relief in the form of a stay of litigation.⁴⁰ But many courts have held that this issue itself must be arbitrated under the provision of the particular arbitration agreement.⁴¹ Again the statutory language is not sufficiently clear to provide adequate protection.

Section 9 provides that the arbitration award may be enforced in court as a judgment.⁴²

³⁹ “§ 3. Stay of proceedings where issue therein referable to arbitration
If any suit or proceeding be brought in any of the courts of the United States upon any issue referable to arbitration under an agreement in writing for such arbitration, the court in which such suit is pending, upon being satisfied that the issue involved in such suit or proceeding is referable to arbitration under such an agreement, shall on application of one of the parties stay the trial of the action until such arbitration has been had in accordance with the terms of the agreement, providing the applicant for the stay is not in default in proceeding with such arbitration.”

⁴⁰ See e.g., *Sphere Drake Insurance Ltd. v. All American Insurance Co.*, 256 F.3d 587, 390-91 (7th Cir. 2001); *Sandvik AB v. Advent International Corp.*, 220 F.3d 99 (3d Cir. 2000); *Chastein v The Robinson-Humphrey Company*, 957 F.2d 851, 854 (11th Cir. 1992). *Three Valleys Mun. Water Dist. v. E.F. Hutton & Co.*, 925 F.2d 1136, 1140 (9th Cir. 1991); *I.S. Joseph Co. v. Michigan Sugar Co.*, 803 F.2d 396, 400 (8th Cir. 1986); *Weis Builders, Inc. v. Kay S. Brown Living Trust*, 236 F.Supp.2d 1197, 1204 (D.Colo.,2002). *Cf.*, *Graham Oil Co. v. Arco Products Co.*, 43 F.3d 1244 (9th Cir. 1995)(arbitration rider contained in franchise contract which waived certain federal statutory rights invalid and not enforceable).

⁴¹ *Bess v. Check Express*, 294 F.3d 1298 (11th Cir. 2002); *Snowden v. Checkpoint Check Cashing*, 290 F.3d 631 (4th Cir. 2002); *Burden v. Check into Cash of Ky., LLC.*, 267 F.3d 483 (6th Cir. 2001).

⁴² § 9. Award of arbitrators; confirmation; jurisdiction; procedure
If the parties in their agreement have agreed that a judgment of the court shall be entered upon the award made pursuant to the arbitration, and shall specify the court, then at any time within one year after the award is made any party to the arbitration may apply to the court so specified for an order confirming the award, and thereupon the court must grant such an order unless the award is vacated, modified, or corrected as prescribed in sections 10 and 11 of this title. If no court is specified in the agreement of the parties, then such application may be made to the United States court in and for the district within which such award was made. Notice of the application shall be served upon the adverse party, and thereupon the court shall have jurisdiction

At this stage a borrower might again have an opportunity to raise the due process challenge to the procedures. However, again, the foreclosure is likely to have been completed by the time the lender completes the arbitration, and reaches a court proceeding. Indeed the lender might even delay seeking court enforcement of an arbitration award until a foreclosure was completed in order to avoid having the due process concerns challenged before the foreclosure sale is accomplished.⁴³ Thus the borrower is likely to have a little opportunity to challenge the lack of procedural protection in the proceeding for the borrowers' interests, particularly if the foreclosure has resulted in the sale of the property to a third party.

Three major arbitration associations have emerged to offer arbitration services to the public under the FAA. These three include: the National Arbitration Forum ("NAF"), the American Arbitration Association ("AAA"), and the "J.A.M.S./Endispute ("JAMS"). The latter entity prohibits the use of unfairly one-sided arbitration agreements.⁴⁴ Allowing the lender to

of such party as though he had appeared generally in the proceeding. If the adverse party is a resident of the district within which the award was made, such service shall be made upon the adverse party or his attorney as prescribed by law for service of notice of motion in an action in the same court. If the adverse party shall be a nonresident, then the notice of the application shall be served by the marshal of any district within which the adverse party may be found in like manner as other process of the court.

⁴³ Following a foreclosure sale under a power of sale to a third party, the borrower's ability to regain her property would likely be limited. CAROLYN L. CARTER, ODETTE WILLIAMSON, JOHN RAO, REPOSSESSIONS AND FORECLOSURES. (National Consumer Law Center 2002) §16.2.6.

⁴⁴ J.A.M.S./Endispute provides as follows in its standards: "1. The arbitration agreement must be reciprocally binding on all parties such that: A) if a consumer is required to arbitrate his or her claims or all claims of a certain type, the company is so bound; and, B) no party shall be precluded from seeking remedies in small claims court for disputes or claims within the scope of its jurisdiction."

foreclose while the borrower is required to spend time arbitrating her defenses may be strikingly one sided, and hence, might not pass muster under this standard. However, other associations have generally permit the use of one-sided riders, and, hence, the issue is not fully addressed.

A wide and diverse body of case law and articles address the issue of whether and how the FAA requirements intersect with requirements of other federal and state statutes. The ability of parties to arbitration contracts to waive their right to a jury trial is one salient issue in this area, as mentioned in Part I, *supra*. Not surprisingly the FAA nowhere addresses whether and how parties might waive or compromise important due process protections. Nothing in the statute addresses this issue expressly. The statute is written so as to ensure that the court determining whether or not to stay litigation in favor of arbitration considers fairly the issues surrounding the validity and enforceability of the AR. Congress surely has no authority through legislation to modify the *Doehr* test, and the FAA should not be read to conflict with it. Hence, the FAA must be read by courts to require them to undertake due process analysis when considering the nature of each rider presented to it. In this sense, the FAA by implication requires each court which becomes involved in enforcing a rider or an arbitration award to consider the extent to which the arbitration process that resulted in the award comported with due process, or not. If the process was lacking, the award should be rejected for enforcement, or new procedures ordered.

Thus, while the FAA provides certain protections for borrowers subject to an arbitration, nothing in the statute or the procedures contemplated by it address the *ex parte* foreclosure issue effectively. Indeed, the riders purporting to make use of *ex parte* procedures undermine the design and intent of the Federal Arbitration Act to enable parties to commercial dealings to resolve their disputes outside of court.

PART III
MODIFICATION OF COURT PROCEDURES
AND LEGISLATIVE REFORMS
TO OBVIATE THESE CONCERNS

Various steps might alleviate the concerns raised here. Courts should scrutinize arbitration agreements for procedural due process violations. Congress should amend the FAA to forbid the use of riders which allow *ex parte* foreclosures⁴⁵ and run afoul of procedural due process.

Courts already often examine riders to determine whether they contravene public policy, certain aspects of state consumer protection procedures, unconscionability, and so on.⁴⁶ However, seemingly no reported court decisions address the due process issues raised by the *ex parte* aspect of contracts that allow for foreclosure during arbitration. Courts could prevent such lender abuse in this area by refusing to stay a borrower's court claims against their lender in favor of arbitration sought by the lender on those claims, and by entering preliminary injunctive relief against foreclosure pending the outcome of the litigation.

Several courts have simply conditioned their grant of a stay of litigation in favor of arbitration by ordering the party seeking the stay to agree to modify the riders in some manner or have severed terms that the court found unacceptable.⁴⁷ A court might order a litigant to agree to

⁴⁵ Indeed, one sided arbitration contracts are used in forms of consumer lending other than the home mortgage industry, should be prohibited by amendments to the FAA as well.

⁴⁶ See Bland, *supra*, *passim*.

⁴⁷ *Arrellano v. Housing Finance Corporation III*, 2002 WL 221604(N.D. Ill. 2002) (lender offered to pay all arbitration costs); *Padilla v. State Farm Mutual Automobile Insurance Company*, 68 P.3d 901 (N.M. 2003)(de novo appeal provision declared void and severed); *Szetela v. Discover Bank*, 97 Cal. App. 4th 1094 (2002)(prohibition of class actions held void but

modify the rider terms to require that all issues, including the foreclosure, be arbitrated at the same time in the same forum.

Finally, Congress should amend the FAA to strengthen its neutrality. The FAA was first enacted in 1925, amended in 1947 and 1954, but has not been substantially amended since. This enactment and these amendments occurred well before the current doctrines of what constitutes procedural due process were developed. *Connecticut v Doehr, supra*, came down in 1991, and well before the use of such *ex parte* provisions became widespread. The FAA should be modified to prohibit such one sided agreements.

Section 2 already provides that riders may be unenforceable under state law because they are unconscionable. The due process concern here arguably falls within this general area of concern. However, laws with regard to unconscionability vary from state to state.⁴⁸ Moreover, different courts within a state view unconscionability from different perspectives. Hence, lack of enforceability under state law may not be the most effective shield with which to alleviate the due process concerns. Section 2 should be amended to preclude the use of arbitration riders which feature *ex parte* provisions dealing with foreclosures and other forms of repossession in consumer agreements.

Section 3 contemplates court scrutiny of riders prior to issuing stays of court litigation in favor of arbitration. This section could be strengthened to make even clearer that all courts, state and federal, should exercise their authority under the FAA in light of their existing duties to avert any due process concerns by rejecting contracts that permit one party access to the court system,

arbitration agreement enforced).

while denying the opposing party such access. Some courts currently simply accede to a clause in an arbitration rider purporting to require that the validity of the rider itself will be the subject of an arbitration. The FAA should not be read to encourage courts to abdicate their constitutional responsibilities to protect the procedural due process aspects of judgments entered.

The caveat that parties may choose to waive certain due process rights can be respected by amending Section 3 of the FAA to require the court to make a determination that any such waiver was knowing, intelligent and voluntary, under the *D. H. Overmyer Co.* standard, *supra*.⁴⁹

Section 4 allows a party to sue in federal court to enforce rider that the opposing party is refusing to honor, even if the opposing party has filed an action in state court on the main dispute.⁵⁰ This section could be amended as well to require the federal court reviewing the rider

⁴⁸ Bland, *supra*, § 11.5.

⁴⁹ See, Bland, *supra*, §3.5.1 et seq.

⁵⁰ § 4. Failure to arbitrate under agreement; petition to United States court having jurisdiction for order to compel arbitration; notice and service thereof; hearing and determination

A party aggrieved by the alleged failure, neglect, or refusal of another to arbitrate under a written agreement for arbitration may petition any United States district court which, save for such agreement, would have jurisdiction under Title 28, in a civil action or in admiralty of the subject matter of a suit arising out of the controversy between the parties, for an order directing that such arbitration proceed in the manner provided for in such agreement. Five days' notice in writing of such application shall be served upon the party in default. Service thereof shall be made in the manner provided by the Federal Rules of Civil Procedure. The court shall hear the parties, and upon being satisfied that the making of the agreement for arbitration or the failure to comply therewith is not in issue, the court shall make an order directing the parties to proceed to arbitration in accordance with the terms of the agreement. The hearing and proceedings, under such agreement, shall be within the district in which the petition for an order directing such arbitration is filed. If the making of the arbitration agreement or the failure, neglect, or refusal to perform the same be in issue, the court shall proceed summarily to the trial thereof. If no jury trial be demanded by the party alleged to be in default, or if the matter in dispute is within admiralty jurisdiction, the court shall hear and determine such issue. Where such an issue is raised, the party alleged to be in default may, except in cases of admiralty, on or before the return neday of the notice of application, demand a jury trial of such issue, and upon such demand the

with an eye towards enforcing it, to withhold enforcement if the rider contains the mix of ex parte provisions and lack of knowing, intelligent and voluntary waiver.

Section 9 permits a party to enforce the award in court provided the rider allows for court enforcement of the award. Again, this section could be amended to alert the enforcing court to scrutinize the rider and the surrounding circumstances to determine whether the due process concerns have been satisfied. As noted, this stage of the proceedings are normally too late for a borrower who has suffered through a foreclosure occurring during the arbitration.

In short, interests of borrowers facing foreclosure can be better protected by the courts regulating the use of the riders and by a series of amendments to the FAA.

CONCLUSION

While arbitration under the FAA may have a significant role to play in the prompt resolution of many sorts of commercial disputes, it has proven severely problematic when applied to defeat the rights of unsophisticated consumers of subprime mortgage lending, and other credit and consumer services. The increasingly common practice of lenders coupling arbitration with an agreement by a borrower not to contest a foreclosure on their house, while other disputes with the lender are subjected to arbitration, may run afoul of the federal Due

court shall make an order referring the issue or issues to a jury in the manner provided by the Federal Rules of Civil Procedure or may specially call a jury for that purpose. If the jury find that no agreement in writing for arbitration was made or that there is no default in proceeding thereunder, the proceeding shall be dismissed. If the jury find that an agreement for arbitration was made in writing and that there is a default in proceeding thereunder, the court shall make an order summarily directing the parties to proceed with the arbitration in accordance with the terms thereof.

Process Clause, and should be rejected, or subjected to careful scrutiny, by courts faced with borrower's litigation challenging such practices. In many instances foreclosures may be carried out without the involvement of a court, such as under a power of sale, and not be subject to Due Process scrutiny. Where, however, the lender asks a court to enforce an *ex parte* arbitration rider against a borrower, the court is bound to examine whether the procedures surrounding a foreclosure meet the three part test under *Connecticut v. Doehr, supra*. If the procedures fail the test, court should stay the foreclosure, strike down the arbitration agreement, or take other measures to avoid any serious risk of erroneous deprivation of the borrower's property.