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Arbitration Agreements That Permit Mortgage Lenders To Initiate Foreclosure Proceedings In Court Are Enforceable In Pennsylvania (Salley v. Option One Mortgage Corp., May 31, 2007)

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June 6, 2007

In a much-anticipated ruling on the applicability of the unconscionability doctrine to arbitration clauses in consumer loan contracts, the Supreme Court of Pennsylvania has rejected the anti-business, anti-arbitration approach taken by some of the lower courts in Pennsylvania. In *Salley v. Option One Mortgage Corp.*, No. 50 EAP 2005, 2007 WL 1583359 (Pa. May 31, 2007), the Supreme Court expressly rejected lower courts' holdings that arbitration clauses in consumer loan contracts that require most disputes to be arbitrated, but that allow *in rem* proceedings (including foreclosures) to proceed in court are unconscionable and unenforceable.

Salley, which was before the Supreme Court on a certified question of law from the U.S. Court of Appeals for the Third Circuit, resolved the tension between the Third Circuit's formulation of Pennsylvania law and a much-criticized opinion the Superior Court of Pennsylvania had issued in 2002. In doing so, the Court sent the message that Pennsylvania courts are not to scrutinize agreements to arbitrate more closely than they scrutinize other consumer contracts, and restores Pennsylvania's historical respect for agreements to arbitrate disputes.

The Controversy Over Lender "Carve-Outs"

The controversy, which is playing out in courts across the country, centers on arbitration agreements lenders frequently use in residential mortgage loan contracts. It is common for lenders who insert arbitration clauses into consumer loan documents to carve foreclosure proceedings and other *in rem* actions out of the arbitration requirement. They do so in the recognition that judicial foreclosure proceedings provide borrowers with considerable statutory protections that would not be available if borrowers were required to defend against a foreclosure in private arbitration. Courts in California, Montana, Tennessee, West Virginia, and Wisconsin have concluded, however, that arbitration agreements that permit creditors to pursue remedies in court, rather than in arbitration, are unconscionable and unenforceable.[1]

This issue first surfaced in Pennsylvania in a case pending in federal court, *Harris v. Green Tree Financial Corp.*, 183 F.3d 173 (3d Cir. 1999). In *Harris*, the Third Circuit predicted that, in view of Pennsylvania's historical respect for private agreements to arbitrate, the Supreme Court of Pennsylvania would not take the arbitration-hostile approach those other courts had adopted. As the Third Circuit reasoned, "the mere fact

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1 *Flores v. Transamerica HomeFirst, Inc.*, 113 Cal. Rptr.2d 376 (Cal. Ct. App. 2002); *Iwen v. U.S. West Direct*, 977 P.2d 989 (Mont. 1999); *Taylor v. Butler,* 142 S.W.3d 277 (Tenn. 2004); *Arnold v. United Companies Lending Corp.*, 511 S.E.2d 854 (W.Va. 1998); *Wisconsin Auto Title Loans v. Janes*, 714 N.W.2d 155, 171-74 (Wis. 2006).

that [the lender] retains the option to litigate some issues in court, while [the borrower] must arbitrate all claims does not make the arbitration agreement unenforceable."

Three years later, however, a panel of the Superior Court of Pennsylvania resoundingly rejected *Harris*. In *Lytle v. CitiFinancial Services, Inc.,* 810 A.2d 643 (Pa. Super. 2002), the Superior Court held that "under Pennsylvania law, the reservation by [a lender] of access to the courts for itself to the exclusion of the consumer creates a presumption of unconscionability, which in the absence of 'business realities' that compel inclusion of such a provision, renders the arbitration provision unconscionable and unenforceable under Pennsylvania law." *Lytle* sent shock waves across the consumer lending industry, particularly with respect to lenders that do significant business in Pennsylvania.

The Supreme Court Of Pennsylvania Rejects Lytle And Adopts A More Even-Handed Approach To Arbitration Agreements

Salley restores Pennsylvania's historical, pre-*Lytle* respect for arbitration agreements in consumer loan contracts. In *Salley*, a low-income homeowner entered into a residential mortgage loan agreement with Option One Mortgage Company, a national subprime lending company. The loan agreement contained a conspicuous "Agreement for the Arbitration of Disputes" that mandated arbitration of most disputes upon any party's request, authorized the arbitrator to award any remedy or relief a court of appropriate jurisdiction could award, but excluded *in rem* proceedings (including foreclosure proceedings against the real property that served as collateral for Mr. Salley's mortgage loan) from arbitration.

When Mr. Salley defaulted on a loan made by another lender, that lender's assignee initiated foreclosure proceedings. In response, Mr. Salley sued Option One and others, seeking to rescind the mortgage loan and recover damages, alleging violations of the Truth in Lending Act and other statutory and common law theories. Option One moved to dismiss Mr. Salley's complaint or in the alternative, to compel arbitration of his claims against it.

Relying on *Lytle*, Mr. Salley argued that the arbitration agreement was unconscionable because it permitted foreclosure actions to proceed in court. The district court, relying on *Harris*, granted Option One's motion to dismiss, and Mr. Salley appealed. In view of the irreconcilable tension between *Lytle* and *Harris*, the Third Circuit certified the question to the Supreme Court.

On May 31, 2007, in a decision lenders in Pennsylvania and across the country will welcome, five Justices of the Supreme Court of Pennsylvania rejected *Lytle's* overt hostility to arbitration agreements in consumer loan contracts.[2] The Court correctly recognized that, under *Doctor's Associates, Inc. v. Casarotto*, 517 U.S. 681 (1996), a court may not construe an agreement to arbitrate differently than the way in which it construes other contracts. State laws that do single out arbitration for special adverse treatment are preempted by the Federal Arbitration Act, 9 U.S.C. § 2.

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2 Mr. Justice Saylor wrote the opinion for the Court, in which Mr. Chief Justice Cappy, and Messrs. Justice Castille, Eakin, and Baer joined. Madame Justice Baldwin filed a dissenting opinion; former Madame Justice Newman did not participate in the decision.

The Court also correctly noted that form contracts (so-called "contracts of adhesion") are not unconscionable as a matter of law in Pennsylvania. And it also agreed with Option One that there is a "facially apparent business justification" for the *in rem* carve-out, because the safeguards that judicial foreclosure proceedings provide benefit lenders and borrowers. Moreover, although reserving some disputes (*e.g.*, foreclosure proceedings) but not others for resolution by a court will result in a split-forum effect, the Court noted that federal and state consumer protection laws "mitigate this burden for meritorious claims."[3]

Although Mr. Salley and his *amici* had urged the Court to consider the "deleterious social effects" of so-called "predatory lending" in deciding the unconscionability question, the Court properly refused to address that aspect of the case, noting that the underlying merits of the parties' larger dispute are for an arbitrator – not the court - to decide. [4]

Ultimately, the Court concluded that, "[u]nder Pennsylvania law, the burden of establishing unconscionability lies with the party seeking to invalidate a contract, including an arbitration agreement, and there is no presumption of unconscionability associated with an arbitration agreement merely on the basis that the agreement reserves judicial remedies associated with foreclosure." The case now returns to the Third Circuit for final adjudication.

The Supreme Court's refusal to apply the unconscionability doctrine in an idiosyncratically rigorous way to arbitration agreements restores Pennsylvania's historical respect for private agreements to arbitrate disputes in all business settings. It comes as a welcome result in particular to financial institutions and other lenders that make consumer loans in Pennsylvania.

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Mark Melodia, a partner in Reed Smith's Financial Services Litigation Group, and Donna Doblick, a partner in the firm's Appellate Group, represented Option One before the Supreme Court of Pennsylvania. Mark and Donna both have extensive experience in consumer loan litigation and disputes involving the enforceability of arbitration agreements.

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3 The Court took its lead in this regard from a similar case the Supreme Court of New Jersey decided last summer, *Delta Funding Corp. v. Harris*, 912 A.2d 104 (N.J. 2006), in which that court was untroubled by a similar foreclosure "carve out," calling it "hardly surprising," since the foreclosure of a residential mortgage "is a uniquely judicial process."

4 *E.g., Prima Paint Corp. v. Flood & Conklin Mfg. Co.,* 338 U.S. 395 (1967); *Buckeye Check Cashing, Inc. v. Cardegna*, 546 U.S. 440 (2006).