

## A Blockbuster of a Case – Arbitration Clause in Online Service Terms Held Illusory

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*In a recent decision in the Northern District of Texas, Harris v. Blockbuster Inc.<sup>1</sup>, the District Court ruled that the arbitration clause in the terms and conditions of the online service for the movie rental company, Blockbuster Inc., is illusory because Blockbuster maintains the right to modify those terms and conditions at any time, and therefore the court refused to enforce the arbitration provision. Most, if not all, online services, social networking sites, online games, virtual worlds and other websites reserve the right to modify their terms of service and terms of use at any time, so this decision, if upheld, could have major implications for any company with an online presence.*

### Background

Blockbuster Online used the “Beacon” ad program of the popular social networking site Facebook. Under this program, Blockbuster’s customers’ video rental selections would be published as part of those customers’ Facebook accounts, including as “news feeds” to Facebook friends of those customers. Plaintiffs, Blockbuster customers with Facebook accounts, sued in federal district court, alleging violation by Blockbuster of the Video Privacy Protection Act (18 U.S.C. § 2710). The VPPA prohibits a movie rental service provider from disclosing consumers’ personally identifiable information, including movie rental selections, to third parties without the informed written consent of the consumer at the time of the disclosure. Blockbuster moved to invoke the arbitration clause in its terms and conditions, which required that all claims be determined by arbitration and which purported to waive the rights of customers to bring a class action lawsuit against Blockbuster. The plaintiffs argued that the arbitration provision is unenforceable because it is illusory, and the court agreed. The plaintiffs also argued that the arbitration clause is unenforceable because it is unconscionable, but, having already ruled the provision to be illusory, the court did not address this issue.

<sup>1</sup> \_\_\_\_\_ (2009 U.S. Dist. Lexis 31531, 3:09-CV-217-M.)

## Court's Analysis

The *Blockbuster* court looked to the *Morrison v. Amway Corp.*<sup>2</sup> decision from the Fifth Circuit in 2008 for guidance on whether the arbitration provision was illusory. In that case, a group of Amway's distributors sued Amway for a variety of contract and tort claims. Each distributor had in place an agreement with Amway that was renewable annually and that allowed Amway to modify terms and conditions from time to time by publication in official Amway literature. Amway did amend its terms in 1997 to include a provision for arbitration as part of the renewal of the agreement, although this was after the disputes at the heart of this case had arisen. When Amway attempted to enforce this arbitration clause in this lawsuit, the court rejected its attempt on the basis that the clause was illusory and unenforceable because Amway's reserved right to modify terms did not expressly exempt disputes arising, or arising out of events occurring, before the effective date of the amendment. In fact, Amway was seeking to enforce the arbitration clause with respect to disputes and matters arising before the arbitration provision was added to the agreement. In this respect, the *Morrison* court distinguished other Texas state law decisions in which the arbitration clause at issue expressly provided that amendments would apply prospectively only, which the *Morrison* court referred to as the "Halliburton type savings clauses" in reference to *In re Halliburton Co.*<sup>3</sup>

The *Blockbuster* court agreed with the reasoning in *Morrison*, noting that Blockbuster's agreement does not have an "express exemption" of the ability to unilaterally modify all rules. As written, the agreement would enable Blockbuster to apply modified terms to disputes that had already arisen. Significantly, the *Blockbuster* court applied this reasoning despite two distinguishing factors from *Morrison*. In *Morrison*, the arbitration provision was a separate agreement that would require independent consideration, whereas the arbitration clause in the Blockbuster case was part of the online service terms. Moreover, in *Morrison*, Amway was actually attempting to enforce the arbitration clause to prior disputes, while in *Blockbuster*, the arbitration clause was part of the online service terms and not an amendment after the fact. Blockbuster's mere reservation of the right to unilaterally modify the online terms was sufficient for the *Blockbuster* court to find the arbitration clause to be illusory.

## Conclusion and Recommendations

The holding in *Blockbuster* is limited to the unenforceability of the arbitration clause in the Blockbuster online terms, and the cases cited in *Blockbuster* dealt primarily with the issue of arbitration clauses (and the cases cited in *Morrison* dealt with arbitration clauses primarily in the employment context). Dispute resolution clauses in online terms, and in particular, waivers of class action consolidation, have been viewed critically by other courts and held unenforceable due to unconscionability.<sup>4</sup> Thus, on the face of it, this ruling would appear to be a narrow one.

However, dicta in *Blockbuster* suggests that the online service terms themselves, not just the arbitration clause, are illusory because of Blockbuster's reserved right to unilaterally modify them. In addition, the *Comb* decision from 2002 as well as the Second Life decision in 2007 were each critical of the online payment service provider's ability to unilaterally modify the online terms, and this factored into the unconscionability analysis. In each of these cases, the court considered the online service provider's

<sup>2</sup> 517 F.3<sup>rd</sup> 248 (5<sup>th</sup> Cir. 2008)

<sup>3</sup> 80 S.W.3<sup>rd</sup> 566 (Tex. 2002)

<sup>4</sup> See, e.g., *Comb v. PayPal, Inc.* (N.D. Cal. 2002) (PayPal's online service agreement held to be procedurally and substantively unconscionable in part because the arbitration clause and limitation of collective action effectively precluded consumers from bringing legitimate claims against PayPal); *Bragg v. Linden Research, Inc.*, 487 F.Supp.2d 593 (E.D. Pa 2007) (arbitration clause for Second Life, a virtual world community, held to be procedurally and substantively unconscionable).

unilateral modification right to be a significant factor demonstrating a lack of mutuality and supporting the finding of substantive unconscionability.

Prior decisions have already required that modifications to online terms be made in a manner to give notice to the user of the changes.<sup>5</sup> The *Blockbuster* decision goes a step further and holds the clause, and perhaps the contract, to be illusory simply because Blockbuster reserved the right to unilaterally modify its online terms. This decision, if not overturned, calls into question a practice, and a contractual term, that most, if not all, online sites and services (including virtual worlds, online games, social networking sites, and even cloud computing providers) have adopted. By maintaining a unilateral right to modify online terms, these sites and service providers may be at risk of their terms being held unenforceable. It is more important than ever that online terms be appropriately and carefully considered before being posted.

Particularly in light of the *Blockbuster* court's reliance on the fact that the Blockbuster agreement did not expressly say that the modifications would apply prospectively, online terms should make it clear that any amendment applies only from the date on which it is added to the online terms and that amended dispute resolution procedures do not apply to any dispute of which the parties had actual notice on the date of the amendment.

Interestingly, Facebook (whose Beacon program is the basis for the Blockbuster case and which has suffered from user outrage to modifications to its service and privacy terms recently<sup>6</sup>) has adopted a new approach to modifying its own online service terms: as announced in February 2009, it is allowing users to vote on whether a new set of terms of use (which has undergone a 30-day comment period from users), or the current Facebook terms should govern the Facebook site.<sup>7</sup> At the time of this writing, the vote has not yet ended. Other online services, particular consumer sites, surely will be watching to see how this experiment turns out and whether Facebook's experience with this approach will usher in a new era for the modification of online terms.

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<sup>5</sup> See *Douglas v. U.S.D.C. Central District of California* (Talk America, Inc.), Case No. 06-75424, July 18, 2007 and Pillsbury's Client Alert "Ninth Circuit Rules Online Contracts Cannot be Changed without Notice to Customers" which can be found at <http://www.pillsburylaw.com/bv/bvisapi.dll/portal/ep/paPubDetail.do/pub/2007827152435718/channelId/-8595/tabId/5/pageTypeld/9208>

<sup>6</sup> See, e.g., Sharon Gaudin, "Are Facebook's outraged users getting a wake-up call?", ComputerWorld, February 18, 2009, available at <http://www.computerworld.com/action/article.do?command=viewArticleBasic&articleId=9128169>

<sup>7</sup> See Facebook press release of February 26, 2009, available at <http://www.facebook.com/press/releases.php?p=85587>