Essay

Early Termination Fees: Fair Game or Federally Preempted?

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Introduction

Few technological developments in the modern era have impacted the day-to-day lives of Americans more significantly than the cell phone. The development of cell phones and the first cellular networks emerged in the latter part of the twentieth century.[1] By 2007, half the global population was "subscribed" to at least one cell phone,[2] making it one of the most ubiquitous electronic devices in the world. With the advent of this mobile communication device, telecommunications giants arose to feed a growing consumer demand. Today, companies such as Verizon Wireless, Sprint Nextel, AT&T, and T-Mobile are household names.

As cell phones and wireless service providers proliferated, so too did monthly service contracts. Americans are all too familiar with the "cell phone plan." Service providers routinely offer discounts on popular cell phone models—a $299 Motorola Razr for as little as $29.99,

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1 Dan Steinbock, The Mobile Revolution: The Making of Mobile Services Worldwide 36–38 (2005).

2 *Global Cell Phone Use at 50 Percent*, Reuters, Nov. 29, 2007, http://www.reuters.com/article/technologyNews/idUSL2917209520071129.

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for instance[3]—in exchange for subscribers' commitments to one- or two-year contracts. The plans offer a set number of daytime minutes and text messages, along with various other add-on features. Indeed, an individual could easily walk into a service provider's store and within minutes be ready to communicate with seemingly anyone in the world from any city in the country. Ah, but with this simple convenience comes a catch—buried in the fine print.

Enter the infamous "Early Termination Fee" ("ETF"). If a subscriber cancels, for instance, a two-year contract before the two years are up, the service provider charges an early termination fee, generally ranging from $150 to $200, depending on the provider and the particular service plan.[4] Whether the subscriber cancels the contract on the same day the plan is first activated or on the day before the contract is to expire, the timing of the cancellation makes little difference: in most instances the provider charges the same fee regardless, although some providers do award a $5 credit for each month paid.[5] Nor do one's reasons for cancelling the contract affect the ETF calculus—mere cancellation triggers the charge.

Understandably, this irks many. John Waudby, for instance, began using Verizon wireless cellular service in 2002.[6] He then upgraded his phone in 2006 and was forced to sign a new two-year contract.[7] The new phone dropped calls repeatedly, causing Waudby to place more than fifty calls to Verizon in an attempt to remedy the problem.[8] The service did not improve, and Waudby understandably cancelled his contract.[9] Subsequently, Waudby discovered that Verizon charged him a $175 early termination fee pursuant to the terms of the contract.[10]

In early 2007, Waudby, on behalf of himself and others similarly situated, filed a class action lawsuit against Verizon.[11] The complaint

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3 *See* AT&T Wireless, Motorola Cell Phones, http://www.wireless.att.com/cell-phone-service/cell-phones/motorola.jsp (last visited Mar. 16, 2009).

4 *See, e.g.*, Verizon Wireless, Customer Agreement, http://www.verizonwireless.com/b2c/globalText?textName=CUSTOMER_AGREEMENT&jspName=footer/customerAgreement.jsp (last visited Mar. 16, 2009) (indicating an early termination fee of $175).

5 *See, e.g.*, *id.* (indicating that the early termination fee is reduced by $5 "for each full month toward [the subscriber's] minimum term that [he] completes").

6 *See* Waudby v. Verizon Wireless Servs., LLC, No. 07-470, 2007 WL 1560295, at *2 (D.N.J. May 25, 2007).

7 *Id.*

8 *Id.*

9 *See id.*

10 *Id.*

11 *Id.*

alleged, among other things, violations of several states' consumer protection statutes; specifically, the complaint alleged that Verizon "disguises a fee to recover equipment costs as a liquidated damages clause, which is an illegal penalty when the damages are readily calculable."[12]

Waudby is not the first to file a suit accusing service providers of violating state consumer protection statutes. In fact, whether ETF contract provisions fall within the reach of state consumer protection statutes has been (and continues to be) litigated contentiously. Outcomes have varied, with some courts holding that state regulation of ETFs is preempted by federal law,[13] other courts holding that state regulation of ETFs is not preempted by federal law,[14] and still other courts staying proceedings[15] until the Federal Communications Commission ("FCC") determines whether ETFs are "rates charged" within the meaning of the relevant statutory provision of the Federal Communications Act ("FCA").[16]

The FCA, which regulates certain aspects of wireless service providers and their relationships with consumers, provides, in pertinent part, that "no State or local government shall have any authority to regulate the entry of or the rates charged by any commercial mobile service or any private mobile service, except that this paragraph shall not prohibit a State from regulating the other terms and conditions of commercial mobile services."[17] Courts divide on this provision's arguably ambiguous language as to whether state-law claims challenging ETFs are preempted.

The ambiguity stems in large part from the meaning of the terms "rates charged" and "other terms and conditions." This ambiguity has proved very costly for service providers. In 2005, to stem the wave of litigation over the issue, and to ensure the preservation of ETF revenues, the Cellular Telecommunications & Internet Association filed a

12 Class Action Complaint at 4, Waudby v. Verizon Wireless Servs., LLC, No. 07-470, 2007 WL 1560295 (D.N.J. May 25, 2007).

13 *E.g.*, Chandler v. AT&T Wireless Servs., Inc., No. 04-180, 2004 U.S. Dist. LEXIS 14884, at *4 (S.D. Ill. July 21, 2004), *dismissed without prejudice by* 2006 U.S. Dist LEXIS 60015 (S.D. Ill. Aug. 24, 2006) (holding that state-law challenge to wireless provider's early termination fee was preempted); Redfern v. AT&T Wireless Servs., Inc., No. 03-206, 2003 U.S. Dist. LEXIS 25745, at *2-*3 (S.D. Ill. June 16, 2003) (same).

14 *E.g.*, Brown v. Wash./Balt. Cellular, Inc., 109 F. Supp. 2d 421, 423 (D. Md. 2000) (holding that because late fees were "other terms and conditions" of service, and not rates, state-law claims were not preempted).

15 *E.g.*, *Waudby*, 2007 WL 1560295, at *6.

16 Federal Communications Act of 1934, 47 U.S.C. §§ 151–615b (2006).

17 *Id.* § 332(c)(2)(A) (2006).

petition with the FCC seeking a declaratory ruling that ETFs are "rates charged" for wireless services within the meaning of § 332(c)(3)(A).[18] Such a ruling, of course, would preempt state consumer protection statutes; state laws purporting to regulate ETFs as illegal penalties or liquidated damages thus would be unavailable to potential plaintiffs. But opposing service providers are state consumer protection advocates, who are seeking to have ETF provisions eliminated from service provider contracts altogether.[19] They contend that ETFs undermine competition and are unfair and unreasonable penalties imposed on consumers.[20]

Settling this dispute is no small matter. Whether ETFs are "rates" within the meaning of the statute places potentially hundreds of millions of dollars at stake. And so it comes as no surprise that judicial resolution of this question is necessary, both from the standpoint of service providers and consumer protection advocates. This Essay explores the merits and demerits of both sides' arguments. Part I addresses the argument of service providers. Part II presents the counterarguments of consumer protection advocates. Part III notes a relatively easy arithmetic fix for service providers, suggesting that ETFs be calculated and imposed as actual damages rather than liquidated damages. Part IV examines the congressional purpose underlying the FCA and correspondingly argues that federal preemption of state-law claims challenging the validity of ETF provisions should obtain.

I. Arguments of Service Providers

The crux of service providers' arguments is quite simple: the federal statute expressly prohibits state regulation of wireless rates. Indeed, on its face the statute seems to bar *any* regulation of rates, while allowing regulation of "other terms and conditions." Service providers argue that the ETF is a component of their rate structure.[21] And

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18 Petition of the Cellular Telecommunications & Internet Association for an Expedited Declaratory Ruling at 2, 4, 28–30, WT Docket No. 194 (F.C.C. filed Mar. 15, 2005).

19 *See, e.g.*, EDMUND MIERZWINSKI, N.Y. PUB. INTEREST RESEARCH GROUP, LOCKED IN A CELL: HOW CELL PHONE EARLY TERMINATION FEES HURT CONSUMERS 3 (2005), *available at* http://www.nypirg.org/consumer/lockedinacellreport.pdf; NAT'L ASS'N OF STATE UTIL. CONSUMER ADVOCATES, EARLY TERMINATION FEES RESOLUTION 2007-03 (June 12, 2007), *available at* http://www.nasuca.org/res/#tele.

20 *See* MIERZWINSKI, *supra* note 19, at 5–6.

21 Joint Reply Memorandum of Points and Authorities in Support of Defendants' Demurrers Re Early Termination Fee Claims at 3–7, *In re* Cellphone Termination Fee Cases, No. 4332, 2006 WL 3256037 (Cal. Super. Ct. June 9, 2006), *rev'd*, No. A115457, 2008 WL 2332971 (Cal. Ct. App. June 9, 2008).

some courts have been receptive to this argument, agreeing that ETFs are an element of the rate calculation, and that federal law therefore preempts any state regulation of such service contract provisions.[22]

To conclude, as service providers do, that ETFs are a component of the rate structure, one must understand the relationship between an ETF, the cost of a cell phone, and the monthly service charge. Service providers heavily discount the price of handsets upfront; at lower prices, cell phones and service plans can be sold to a greater number of consumers, thereby significantly increasing market penetration. Indeed, the greatest barrier to entry into the cell phone market is often the generic cost of the mobile device itself (absent a provider-subsidized discount).[23] Presumably, service providers are able to recoup the cost of this initial discount only through the monthly subscriber fees generated throughout the life of the contract. Because the provider knows that a breach of the service contract will generate a fixed income, providers can more easily anticipate their revenue and cost streams. In turn, they are able to offer older cell phone models to consumers for free. To those who do not seek to break the terms of the contract, this is a win-win situation.

Often, providers offer varying monthly rates for cell phone service depending upon whether a consumer signs a one- or two-year contract. The ETF varies depending upon the consumer's package and the anticipated amount of service time. The ETF allows a carrier to recoup lost anticipated profits from a consumer's breach of the contract he or she initially signs. The service provider must be assured of "an income stream of sufficient duration [in order to] cover costs and provide a profit."[24]

If service providers are unable to recoup the costs of providing heavily discounted mobile devices upfront, the alternatives are clear: they will be forced to charge either a significantly higher price for the devices themselves or a significantly higher per-month price for service. Either becomes a barrier to entry into the cell phone market for the individual consumer, and fewer Americans will be able to reap the benefits of cell phone service. The ETF is thus directly linked to the

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22 *See* Chandler v. AT&T Wireless Servs., Inc., No. 04-180, 2004 U.S. Dist. LEXIS 14884, at *4 (S.D. Ill. July 21, 2004), *dismissed without prejudice by* 2006 U.S. Dist LEXIS 60015 (S.D. Ill. Aug. 24, 2006); Redfern v. AT&T Wireless Servs., Inc., No. 03-206, 2003 U.S. Dist. LEXIS 25745, at *2–3 (S.D. Ill. June 16, 2003).

23 *See In re* Policy and Rules Concerning the Interstate, Interexchange Marketplace, 16 F.C.C.R. 7418, 7423 (2001).

24 *See* Phillips v. AT&T Wireless, No. 4:04-CV-40240, 2004 WL 1737385, at *7 (S.D. Iowa July 29, 2004).

rates charged to consumers, providers argue. But is a factor *impacting* a rate enough to make the ETF a *component* of the "rates charged" within the meaning of the statute?

If nothing else, evaluating "rates" is a far more complicated undertaking than merely referencing cost per unit of time. "Rates . . . do not exist in isolation. They have meaning only when one knows the services to which they are attached."[25] It is therefore important to examine the context of the fee and the rate. In context, a fee which would otherwise seem to be isolated from the rate charged may in fact become a component of the rate if the fee is attached to a service reflected in the rate. The ETF is a "central element of the rate structure that compensates defendants for the upfront services they provide to their customers."[26] Without the ETF, the rate goes up. In this way, the ETF is part of the fee charged for a service rendered. This is the service providers' approach to arguing that the ETF is directly related to the monthly rate charged.

The FCC has concluded that "the term 'rates charged' [in § 332(c)(3)(A)] may include both rate levels and rate structures . . . and that the states are precluded from regulating either."[27] Because the ETF has a direct bearing on the rate charged to customers, it is an integral element of the rate *structure*, and any state-law regulation is therefore preempted because, as the statute makes clear, "no State . . . shall have any authority to regulate . . . the rates charged . . . ."[28] Of course, there can be little doubt that if states do have the authority to regulate ETFs, and if states use that authority to ban ETF provisions under state law, the rates charged to consumers for service contracts will be affected directly. Consumer advocates, however, see things a bit differently.

II. Arguments of Consumer Protection Advocates

Whereas service providers contend that the FCA preempts state regulation of ETFs, class action lawyers and consumer advocates believe that state regulation of ETFs is a valid exercise of state authority. Consumer advocates begin, as do service providers, with the statutory language. Although the statute prohibits states from regulating *rates*, the FCA expressly does not prohibit a state from "regulating the *other*

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25 AT&T v. Cent. Office Tel., Inc., 524 U.S. 214, 223 (1998).

26 Joint Reply Memorandum of Points and Authorities in Support of Defendants' Demurrers Re Early Termination Fee Claims, *supra* note 21, at 4.

27 Ball v. GTE Mobilnet of Cal., 96 Cal. Rptr. 2d 801, 807 (Cal. Ct. App. 2000).

28 *See* 47 U.S.C. § 332(c)(3)(A) (2006).

terms and conditions of commercial mobile services."[29] The thrust of this argument, then, is that ETFs are "other terms and conditions," not "rates."

Consumer advocates are quick to point out that *any* cost associated with running a cell phone service could potentially impact a service provider's bottom line, and thus might affect the rates charged to consumers. For instance, when a service provider pays ten million dollars to settle an employment discrimination lawsuit brought against it, this settlement cost is eventually passed on to the consumer, likely in the form of higher rates. Merely because a cost *impacts* the rate does not necessarily mean that the cost *is* a rate within the meaning of section 332(c)(3)(A). Or so argue consumer protection advocates.

And at first glance, this argument is appealing. There is a meaningful distinction between a cost on the one hand that *impacts* a rate (and is thus fair game for regulation) and a cost on the other hand that is a *component* of the rate (and is thus not subject to regulation). Some courts have accepted this argument.[30] If a rate were to include any action that indirectly impacted rates, "the exception would be swallowed by the rule."[31] Congress could not have intended this result because it expressly included a savings clause in the statute[32]: "[n]othing in this chapter contained shall in any way abridge or alter the remedies now existing at common law or by statute, but the provisions of this chapter are in addition to such remedies."[33] Indeed, if any regulation that affected a service provider's business could be classified as a regulation of "rates," then any action impacting the service provider would be federal in nature.[34]

Additionally, proponents of state-law regulation of ETFs advance the argument that the ETF is a penalty billed to a consumer for a breach of contract.[35] The ETF bears no relation to a charge for airtime or minutes used, or any particular fee for services rendered,[36] and

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29 *See id.* (emphasis added).

30 *See, e.g.*, Phillips v. AT&T Wireless, No. 4:04-CV-40240, 2004 WL 1737385, at *7 (S.D. Iowa July 29, 2004) (joining those courts which had rejected "the arguments that 'anything that might touch upon [a wireless provider's business]' is a challenge to rates in the sense that an adverse ruling would increase 'business expenses' that 'would likely be passed on to customers as rate increases'").

31 Iowa v. U.S. Cellular Corp., No. 4-00-CV-90197, 2000 WL 33915909, at *5 (S.D. Iowa Aug. 7, 2000).

32 *See Phillips*, 2004 WL 1737385, at *9.

33 47 U.S.C. § 414 (2006).

34 *Id.*

35 *See, e.g.*, *id.*

36 *See Phillips*, 2004 WL 1737385, at *9.

the same fee is assessed regardless of *when* during the life of the contract the service agreement is terminated.[37] What's more, if both parties perform the contract completely, no fee is ever assessed. As a result, consumer advocates argue, an ETF is not part of the rate structure; rather, it is a liquidated damages provision that is captured under the illegal penalty provisions of many state consumer protection statutes.[38]

III. A Quick Fix for Service Providers: Do the Math

Whether or not an ETF is a "rate" within the meaning of the FCA, there seems to be at least one possible solution that might appease cell phone service providers and customers alike. Some state consumer protection laws may be applicable where, despite damages being readily calculable, an arbitrarily imposed penalty is assessed. There is little doubt that a consumer who terminates a service provider contract prior to the expiration of the contract has breached the contract that he or she initially signed. The question, then, is what damages should be applied. To be sure, cell phone companies prefer the ETF because it can be assessed easily and efficiently. In the interests of business administrability, assessing a single fee regardless of circumstance seems logical.

But as providers have seen, ETFs have generated costly, prolonged litigation, to say nothing of consumer ill will. Service providers can avoid the issue entirely by simply applying a little arithmetic skill in order to determine the *actual damages* to the company. That is, rather than risk a judicial determination that the ETF is a penalty, service providers can adjust the amount of the fee based on a series of

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37 *See id.* Some providers now offer a $5 credit for each month paid on the contract. *See supra* note 5.

38 Some courts have also found that the FCA does not preempt a variety of arguably rate-sensitive causes of action under state consumer protection statutes and common law. *See, e.g.*, Marcus v. AT&T Corp., 138 F.3d 46, 53–55 (2d Cir. 1998) (claims alleging fraudulent billing practices not completely preempted under FCA); Sanderson, Thompson, Ratledge & Zimny v. AWACS, Inc., 958 F. Supp. 947, 954–58 (D. Del. 1997) (claims alleging improper practice of rounding up all calls to the next highest minute in computing billing charge not completely preempted under FCA); Bauchelle v. AT&T Corp., 989 F. Supp. 636, 643–49 (D.N.J. 1997) (claims alleging fraud in provider's failure to disclose the least-expensive calling plan not completely preempted under FCA); DeCastro v. AWACS, Inc., 935 F. Supp. 541, 548–53 (D.N.J. 1996) (claims alleging fraud in provider's failure to disclose practice of billing customers when a call is initiated, rather than when a connection is made, not completely preempted under FCA); Weinberg v. Sprint Corp., 165 F.R.D. 431, 437–39 (D.N.J. 1996) (claims alleging provider's failure to disclose billing practice of "rounding up" all calls to the next full minute not completely preempted under FCA).

considerations, including the type of service plan and the time remaining until the contract's expiration date. After all, the ETF is designed, according to the service providers, to compensate them for the initial discount on the mobile device itself; because they know the cost of the device and the amount of profits lost due to the breach, they should be able to calculate economic loss. By assessing the actual damages caused by the breach to the breaching party, the fee charged for early termination avoids any liquidated damages concerns.

The damages are indeed readily calculable. For instance, assume that a provider expects to earn a $200 profit on a consumer during the life of a two-year contract and, due to this anticipated profit, discounts a $200 phone to $100. Here, if the customer breached in the first month of the contract, the loss incurred by the service provider would be $100.[39] The service provider need only divide the discount (here, $100) by the number of months in the contract (here, twenty-four) to arrive at a monthly damages number. Thus, if a consumer breaches with ten months remaining on the contract, a simple multiplication of the number of months' worth of profits lost by the number of months remaining on the life of the contract yields a fairly accurate measure of actual damages. The appropriate damage award is readily calculable from the point of view of the service providers. This approach avoids entirely the problem of a liquidated damages provision and at the same time compensates the service providers for the breach of contract.

Granted, this example is stylized and oversimplified (there are many more costs and fees involved, and as the months progress, the actual damages number would be altered slightly), but the basic philosophy behind the approach is sound. Simple methods of accounting would seem to be an easy way for cell phone companies to avoid state consumer protection statutes if the FCC and the courts ultimately determine that ETFs are not "rates" within the meaning of section 332(c)(3)(A), but rather are "other terms and conditions" and thus subject to state regulation.

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39 The service provider gave a $100 discount on the price of the phone and was unable to recoup the discount from the service contract's monthly fees. Because cell phone service plans are typically billed on a monthly basis, the actual damages calculation should be tied to the month in which termination of the contract occurs. Although prorating actual damages to the day is also a possibility, it is beyond the scope of this example.

IV. Applying Preemption Best Satisfies the Purpose of the FCA

Of course, the above-described approach to preventing future ETF conflicts does little to address pending litigation. Nor does it offer much guidance to the FCC or courts with respect to whether ETFs are "rates" within the meaning of the statute. As discussed, both proponents and opponents of ETFs advance reasonable and persuasive arguments. Indeed, even the courts themselves have reached divergent conclusions as to whether ETFs are "rates" within the meaning of the statute. That we have arrived at an impasse counsels in favor of turning to the congressional purposes underlying the statute and asking which solution most closely tracks what Congress had in mind when it enacted the FCA. Remaining true to a statute's purpose in deciding difficult questions helps alleviate concerns that the legislative will of Congress is being subverted by an active judiciary.

The "rates" provision at issue was enacted as part of the Omnibus Budget Reconciliation Act of 1993.[40] Congress subsequently articulated its purpose behind this scheme when it passed more comprehensive telecommunications legislation in 1996: to provide for a "pro-competitive, de-regulatory national policy framework designed to accelerate rapidly private sector deployment of advanced telecommunications and information technologies and services to all Americans."[41] An appeal to enhancing a national policy designed to advance the technology itself therefore will appropriately address the will of Congress.

Mobile services by definition do not operate within the confines of a single state's borders, and thus federal regulation of various aspects of the telecommunications industry is both practical and legitimate. From the perspective of the FCC, it would seem that uniform regulation at the federal level would not only be beneficial, but would make sound, practical sense. By their nature, cell phones are difficult to place conceptually within a single state's borders. They access satellites and towers placed throughout the globe and allow one to communicate with billions instantly. Geographical constraints have little meaning within the industry.

If the statutory purpose is to facilitate rapid advancement of the telecommunications industry in the United States by emphasizing a deregulatory (or at least a nonconflicting regulatory) environment, the

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40 Omnibus Budget Reconciliation Act of 1993, Pub. L. No. 103-66, 107 Stat. 312 (codified in scattered sections of 7, 26, and 42 U.S.C.).

41 H.R. Rep. No. 104-458, at 113 (1996) (Conf. Rep.), *reprinted in* 1996 U.S.C.C.A.N. 124, 124.

FCC would be best served to federally preempt state regulation of ETFs. Given the significant mobility of the industry's consumers, uniform federal regulation is more appropriate than piecemeal state regulation. At present, cell phone service providers spend tens of millions of dollars defending against state consumer protection statutes attempting to regulate ETFs. All this litigation expense is ultimately passed on to the consumer in the form of increased charges; simultaneously, litigation expenses divert funds away from supporting infrastructure upgrades and new product innovation.

To facilitate and enhance the purpose of the statute, the FCC (and courts) should determine that ETFs are "rates" within the meaning of § 332(c)(3)(A). Doing so would enable service providers to invest the money they currently spend defending suits into improving network access and infrastructure or customer service for consumers. In addition, service providers would be subject to a single form of regulation with respect to ETFs, as opposed to a patchwork of various state rules and regulations.

Conclusion

As discussed, both sides of the debate present legitimate arguments. On the one hand, service providers do set their rates on the assumption that a breach by a consumer will subject them to a known termination fee. This allows them to discount heavily the price of the cell phones themselves. On the other hand, consumer protection advocates note that the damages calculation is easily identifiable, and states certainly can regulate "other terms and conditions" per the language of the statute itself. The appropriate solution rests in following Congress's purpose in enacting the statute—to facilitate the rapid deployment of a beneficial technology like mobile communication. To achieve this goal most effectively, the FCC should determine that ETFs are "rates" within the meaning of § 332(c)(3)(A). State regulation of ETF contract provisions would thus be federally preempted.