SUPREME COURT HOLDS STATE LAW INVALIDATION OF ARBITRATION PROVISION AS UNCONSCIONABLE PREEMPTED BY FEDERAL ARBITRATION ACT

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In *AT&T v. Concepcion*, the United States Supreme Court considered the validity of an arbitration provision that provided for the arbitration of all disputes between the parties to a contract, but required that claims be brought in the parties' "individual capacity, and not as a plaintiff or class member in any purported class or representative proceeding." *AT&T Mobility, LLC v. Concepcion*, No. 09-893, 2011 WL 1561956, at *3 (Apr. 27, 2011) (slip op. at 1). The District Court followed California state law in holding that the arbitration provision was unconscionable because AT&T had failed to demonstrate that arbitration adequately substituted for the benefits of class actions. In a similar vein, some other courts have held that contractual waivers of class wide arbitration are unconscionable and unenforceable. The Ninth Circuit affirmed. The Supreme Court granted certiorari to address the question of whether the Federal Arbitration Act "prohibits States from conditioning the enforceability of certain arbitration agreements on the availability of class wide arbitration procedures." The Court answered the question in the affirmative.

This opinion followed, and cited, the Court's recent opinion in *Stolt-Nielsen S.A. v. AnimalFeeds Int'l Corp*., 130 S. Ct. 1758, 1775 (2010), which held that class arbitration could not be compelled unless it was specifically provided for by arbitration contract. The Court has also held that parties may, by contract, limit the issues subject to arbitration, *Mitsubishi Motors Corp.* v. *Soler Chrysler-Plymouth, Inc.*, 473 U.S. 614, 628 (1985), require that arbitration be conducted according to specific rules, *Volt Information Sciences, Inc. v. Board of Trustees of Leland Stanford Junior Univ.*, 489 U.S. 468, 479 (1989), and limit with whom a party will arbitrate its disputes, *Stolt-Nielsen*, 130 S.Ct. at 1774. The basic principle underlying these rulings is that arbitration is contractual, and that the FAA ensures that arbitration agreements, like all contracts, are enforced according to their terms. *See also Volt*, 489 U.S. at 478 (1989).[1]

[1] The power to contract has limits, however, and cannot vary the express terms of the FAA. In *Hall Street Assoc. LLC v. Mattel, Inc.*, 552 U.S. 576 (2008), the Supreme Court held that the FAA provides the sole bases for courts vacating or modifying arbitration awards, and that the parties could not, by contract, establish standards for judicial review that were contrary to, or in addition to, those provided for in the FAA.

The California *Discover Bank* Rule

The California law principle relied upon by the District Court and the Ninth Circuit is known as the *Discover Bank* rule, which provides that class action waivers contained in arbitration agreements attached to consumer adhesion contracts are unenforceable in certain circumstances. California's *Discover Bank* rule provides that:

> [W]hen the waiver is found in a consumer contract of adhesion in a setting in which disputes between the contracting parties predictably involve small amounts of damages, and when it is alleged that the party with the superior bargaining power has carried out a scheme to deliberately cheat large numbers of consumers out of individually small sums of money, then . . . the waiver becomes in practice the exemption of the party 'from responsibility for [its] own fraud, or willful injury to the person or property of another.' Under these circumstances, such waivers are unconscionable under California law and should not be enforced.

Discover Bank v. Superior Court., 36 Cal. 4th 148, 162 (2005) (quoting Cal. Civ. Code Ann. §1668).

The Background of the *AT&T* Case

The underlying dispute in *AT&T* arose out of a consumer adhesion contract relating to the sale of cellular telephones. In February 2002, Mr. and Mrs. Concepcions entered into an agreement for the sale and servicing of cell phones. The adhesion contract provided for arbitration of all disputes, but mandated that all claims were to be in the parties' individual capacity. The agreement specifically prohibited the Concepcions from serving as a representative plaintiff or as a class member in a class action proceeding. The Concepcions purchased AT&T's cell phone service, which had been advertised as including free telephones. Though they were not charged for the phones themselves, they were charged $30.22 in sales tax based on the phones' retail value. The Concepcions filed an action in the United States District Court for the Southern District of California, which was ultimately consolidated with a putative class action alleging false advertising and fraud by AT&T.

AT&T, for its part, moved to compel arbitration pursuant to the contract. The Concepcions opposed, alleging that the agreement was unconscionable and exculpatory. The District Court relied upon the California Supreme Court's decision in *Discover Bank v. Superior Court*, 36 Cal. 4th 148 (2005), and held that the arbitration provision was unconscionable because AT&T had failed to demonstrate that arbitration adequately substituted for the benefits of class actions. The Ninth Circuit Court of Appeals affirmed the District Court's decision, also relying upon *Discover Bank.* The Court of Appeals explicitly ruled that the *Discover Bank* rule was not preempted by the Federal Arbitration Act because the rule was "a refinement of the

unconscionability analysis applicable to contract generally in California." *Laster v. AT&T Mobility LLC*, 584 F. 3d 849, 857 (2009).

The Plurality Opinion

In a 5-4 decision, the Supreme Court held that the California unconscionability rule is preempted by the Federal Arbitration Act. Justice Antonin Scalia, writing for the majority, which consisted of four Justices, emphasized the liberal federal policy favoring arbitration and concluded that courts must enforce arbitration agreements according to their terms as with other contracts. Justice Scalia further held that the underlying purpose of arbitration – streamlined and efficient proceedings – was frustrated by class arbitration's inherently complicated nature. Chief Justice Roberts and Justices Kennedy, Thomas, and Alito joined in the opinion; Justice Thomas filed a separate concurrence. Justice Breyer filed a dissenting opinion, in which Justices Ginsburg, Sotomayor, and Kagan joined.

Section 2 of the Federal Arbitration Act makes agreements to arbitrate "valid, irrevocable, and enforceable, save upon such grounds as exist at law or in equity for the revocation of any contract." 9 U.S.C. §2. The FAA was enacted in 1925 as a Congressional response to pervasive judicial hostility to arbitration agreements. The Supreme Court has previously described § 2 as evidence of a "liberal federal policy favoring arbitration." *Moses H. Cone Memorial Hospital v. Mercury Constr. Corp.*, 460 U.S. 1, 24 (1983). In keeping with that policy, the Court has repeatedly held that arbitration agreements must be viewed as "on equal footing" with all other contracts and thus should be enforced according to their terms. Slip op. at 5 (citing *Buckeye Check Cashing, Inc. v. Cardegna*, 546 U.S. 440, 443 (2006); *Volt Information Sciences, Inc. v. Board of Trustees of Leland Stanford Junior Univ.*, 489 U.S. 468, 478 (1989)).

Section 2, however, also contains a "savings clause" which permits arbitration agreements to be considered unenforceable "upon such grounds as exist at law or in equity for the revocation of any contract." 9 U.S.C. §2. The Court has held that this clause permits agreements to arbitrate to be invalidated by "'generally applicable contract defenses, such as fraud, duress, or unconscionability' but not by defenses that apply only to arbitration or derive their meaning from the fact that an agreement to arbitrate is at issue." *Concepcion*, 2011 WL 1561956, at *5 (slip op. at 5) (quoting *Doctor's Associates, Inc. v. Casarotto*, 517 U.S. 681, 687 (1996)).

The Concepcions argued in the instant case that the *Discover Bank* rule falls under § 2's savings clause because it was borne out of California's long standing unconscionability doctrine and policy against exculpation. Alternatively, they argued that even if the rule is considered a prohibition on class action waivers, "the rule would still be applicable to all dispute resolution contracts, since California prohibits waivers of class litigation as well." In response, AT&T

argued that the rule stands in stark opposition to the FAA, and accordingly "[t]he conflicting rule is displaced by the FAA." *Concepcion*, 2011 WL 1561956, at *6 (slip op. at 7) (citing *Preston v. Ferrer*, 552 U.S. 346, 353 (2008)). Justice Scalia noted that the inquiry is complicated when the applicable doctrine is being applied in a manner that generally disfavors arbitration. *Id.*

Writing for the Court, Justice Scalia determined that the *Discover Bank* rule was preempted by the FAA. The plurality opinion explained that "[t]he overarching purpose of the FAA, evident in the text of §§2, 3, and 4, is to ensure the enforcement of arbitration agreements according to their terms so as to facilitate streamlined proceedings." *Concepcion*, 2011 WL 1561956, at *8 (slip op. at 9). Justice Scalia found that FAA § 2's saving clause preserved generally applicable contract defenses but did not act to preserve state-law rules that stand as an obstacle to the accomplishment of the FAA's objectives. Citing a prior Supreme Court case involving AT&T, Justice Scalia explicated that a statute's savings clause "'cannot in reason be construed as [allowing] a common law right, the continued existence of which would be absolutely inconsistent with the provisions of the act. In other words, the act cannot destroy itself.'" *Id.* at 7 (slip op. at 9) (quoting *American Telephone & Telegraph Co. v. Central Office Telephone, Inc.*, 524 U.S. 214, 227-28 (1998) (further citations omitted)). Accordingly, to allow a state to completely frustrate the purpose of the FAA by eliminating all class action arbitration waivers by means of the FAA's savings clause would destroy the FAA itself.

Justice Scalia further ruled that the class arbitration mandate created by *Discover Bank* was not consensual and thus violated a fundamental attribute of arbitration that parties are free to limit with whom they will arbitrate. Additionally, the purpose behind allowing parties discretion in designing and choosing arbitration procedures is to create an efficient streamlined dispute resolution process. Noting the difficulties associated with resolving class disputes via arbitration, Justice Scalia determined that class arbitration will likely complicate dispute resolution rather than streamline it and consequently a fundamental purpose of the FAA will be frustrated.[2] *Concepcion*, 2011 WL 1561956, at *8-10 (slip op. at 11-12). Because the rule allows any party to a consumer contract to demand arbitration *ex post*, the *Discover Bank* rule interferes with arbitration itself. *Id.* at *10 (slip op. at 12). Moreover, to the extent that the *Discover Bank* rule manufacturers non-consensual class arbitration, it runs afoul of the FAA and the Court's ruling in *Stolt-Nielsen.*

For these reasons, the plurality opinion held that the California state law stood as an obstacle to the accomplishment and execution of the full purposes and objectives of the FAA and the *Discovery Bank* rule was accordingly preempted by the FAA. The Court reversed and remanded the Ninth Circuit's judgment.

[2] Justice Scalia notes that (a) the informality of arbitration is likely to generate "procedural morass" in a class setting; (b) class arbitration *requires* procedural formality; and (c) class arbitration greatly increases risks to defendants. *Concepcion*, 2011 WL 1561956, at * 10-11 (slip op. at 14-16). Thus, class disputes are generally ill-suited to arbitration. *Id.*

The Separate Opinions

Justice Clarence Thomas filed a concurring opinion, which contributed to the 5-4 majority ruling, explaining that he "reluctantly join[ed] the Court's opinion." The Justice wrote separately to emphasize his view that § 2 stands for the proposition that "courts cannot refuse to enforce an arbitration agreement because of a state public policy against arbitration, even if the policy nominally applies to 'any contract.'" *Concepcion*, 2011 WL 1561956, at *13, Thomas, J., concurring. Justice Thomas read the FAA to require that an agreement to arbitrate be enforced "unless a party successfully challenges the formation of the arbitration agreement, such as by proving fraud or duress." *Id.* at *14. This reading reached the same result as explained in Justice Scalia's plurality opinion (and it would reach the same conclusion in most circumstances).

In a dissent joined by Justices Ginsburg, Sotomayor, and Kagan, Justice Breyer argued that the *Discover Bank* rule was not preempted by the FAA and was, in fact, consistent with both the language and primary objective of the FAA. In Justice Breyer's view, the California rule did not create a blanket prohibition against class action waivers, but, rather, represented the "application of a more general unconscionability principle." *Concepcion*, 2011 WL 1561956, at *17, Breyer, J., dissenting (citations omitted). In support of this position, Justice Breyer cited a number of California state cases that upheld class action waivers where the state courts found that the waiver satisfied general unconscionability standards. *Id.* (citations omitted). Further, the *Discover Bank* rule was consistent with the FAA's language because it applied "equally to class action litigation waivers in contracts without arbitration agreements as it does to class arbitration waivers in contract with such agreements." *Id.* (citing *Discover Bank*, 36 Cal. 4th at 165-166)). Justice Breyer concluded that the *Discover Bank* rule was consistent with the basic purposes of the FAA because the primary objective of the Act was not to guarantee certain procedural advantages, but to secure the "enforcement" of agreements to arbitrate. *Id.* at *18 (citing *Dean Witter Reynolds, Inc. v. Byrd*, 470 U.S. 213, 221 (1985). Justice Breyer took particular issue with Justice Scalia's argument that the *Discover Bank* rule increased the complexity of arbitration procedures, thereby discouraging parties from entering into arbitration agreements. He noted that, as a practical matter, an attorney would be unlikely to take a case like the Concepcion's where the damages amounted to the paltry figure of $30.22.

Conclusion

AT&T v. Concepcion stands as a marked victory for corporate interests. As noted by both the plurality and dissenting opinions, virtually all consumer contracts are contracts of adhesion. By overturning California's *Discover Bank* rule (and calling into question the similar rules currently existing in 18 other states), the Court provided companies a tool to attempt to avoid class arbitrations. Coupled with *Stolt-Nielson*, the Court has now accorded parties the right to determine, by contract, whether and under what circumstances they will engage in class arbitrations. The contractual language that the Court found sufficient to avoid class wide

arbitration was simple. The broader principle underlying this decision of the supremacy of the Federal Arbitration Act over state common law might have broader implications for contracting and for dispute resolution procedures.

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