Consumer Contracts and Class Actions

U.S. Supreme Court to Decide Whether State Unconscionability Law Bars Mandatory Individual Arbitration of Claims

by Frank A. Luchak

While class actions continue to grow in importance as a means of resolving consumer disputes with U.S. businesses that provide credit cards, consumer lending, wireless telephones and other services, such providers customarily rely upon consumer agreements that include arbitration provisions that expressly waive the parties' right to bring class actions and instead require individual arbitration of all disputes.

Consumers seeking recovery of damages for alleged violations of their consumer agreements often seek to join together to redress their grievances in the form of class actions, notwithstanding the language in their agreements waiving their right to bring any claims in court and their election of individual arbitration.

Relying upon the Federal Arbitration Act[1] (FAA) and the supremacy clause of the United States Constitution, in New Jersey, California and many other states, consumer class actions in such situations are greeted with motions to compel individual arbitration and stay all court proceedings. A number of state and federal courts, applying state law to such class action waivers, notwithstanding the fact they are engrafted to provisions that require arbitration of all disputes arising out of the consumer agreement in which they reside, have nevertheless refused to enforce class action waivers because they are deemed unconscionable under state law. Thus, the Ninth Circuit, in *Laster v. AT&T Mobility LLC*[2] (commonly known by the title of a related case *Concepcion v. AT&T Mobility LLC*),[3] applying California law; the New Jersey Supreme Court, in *Muhammed v. County Bank of Rehoboth Beach, Delaware;*[4] and the Third Circuit in *Homa v. American Express Co.*,[5] applying New Jersey law, all relying upon the California Supreme Court's 2005 decision in *Discover Bank v. Superior Court of Los Angeles*,[6] have declared consumer contracts with class action waivers contained within their arbitration provisions unconscionable under California and New Jersey law, respectively, and have held the FAA does not preempt the application of the law of those states to preclude enforcement of a class-wide arbitration waiver.

Concepcion has been appealed to the United States Supreme Court by AT&T Mobility, the wireless provider to the Concepcions. It was argued on Nov. 9, 2010, and is presently awaiting decision. This appeal has been closely watched by the business press and could "profoundly" shape American class action law.[7] Many federal courts have stayed putative consumer class actions with similar class action waivers in arbitration provisions to await guidance that the Supreme Court may offer when it decides *Concepcion*. Before *Concepcion* and its potential implications are discussed, it is important to understand the FAA and its genesis.

The Federal Arbitration Act

Arbitration was historically viewed with great hostility by state and federal courts alike, and arbitration agreements, although they were contracts between the parties like any other, were often not enforced. Eventually Congress acted,

and in 1925 it enacted the United States Arbitration Act, as the FAA was then known, "for the express purpose of making 'valid and enforceable written provisions or agreements for arbitration of disputes arising out of maritime transactions, or commerce among the States or Territories or with foreign nations.'"[8] Hence, arbitration provisions are generally enforceable. Such agreements should be treated by the courts on the same footing as ordinary contracts, and courts have the duty under the FAA to compel arbitration "in accordance with the terms of the [arbitration] agreement"[9] and, to stay litigation of arbitral claims pending arbitration "in accordance with the terms of the [arbitration] agreement."[10]

However, as reenacted and codified in 1947,[11] the FAA affirmatively preempts any state law limitation on the enforceability of arbitration agreements contained in written contracts involving commerce, "save upon such grounds as exist at law or in equity for the revocation of any contract."[12] Stated differently, if a state law ground to revoke an arbitration clause is not also applicable as a defense to revoke a contract in general, the state law principle is preempted by the FAA.

This 'savings clause' in Section 2 of the FAA has been viewed as intended to preserve state law where it could be employed to invalidate "any contract," and thus prevent arbitration agreements from being accorded a preferred status.[13] The Supreme Court has previously summarized this so-called "anti-discrimination principle" in a famous footnote in *Perry v. Thomas*,[14] as follows:

> [S]tate law, whether of legislative or judicial origin, is applicable *if* that law arose to govern issues concerning the validity, revocability, and enforceability of contracts generally. A state-law principle that takes its meaning precisely from the fact that a contract to arbitrate is at issue does not comport with this requirement of § 2. A court may not, then, in assessing the rights of litigants to enforce an arbitration agreement, construe that agreement in a manner different from that in which it otherwise construes nonarbitration agreements under state law. Nor may a court rely on the uniqueness of an agreement to arbitrate as a basis for a state-law holding that enforcement would be unconscionable, for this would enable the court to effect what we hold today the state legislature cannot.

Moreover, when determining the enforceability of an arbitration agreement, "there is a presumption in favor of arbitrability."[15]

Against this backdrop, the Ninth Circuit Court of Appeals was called upon to review the district court's refusal to enforce the arbitration provision in the Concepcions' wireless service agreement (WSA) with AT&T Mobility.

Concepcion in the District Court

In *Concepcion*, the plaintiffs contracted for cellular phone service and the purchase of new cell phones. Although the Concepcions received the cell phones without charge for the devices themselves because they agreed to a two-year contract term, AT&T charged them $30.22 total in sales tax for two plans, calculated at 7.75 percent of both phones' retail value. The WSA included an arbitration provision and a class action waiver clause together, which required that any dispute be arbitrated between the parties in an individual capacity. During the term of the WSA, but after the complaint was filed, AT&T amended the agreement to pay the customer a $7,500[16] "premium" payment if the arbitrator issues an award in favor of a California customer that is greater than AT&T's last written settlement offer made before the arbitrator was selected.

The Concepcions' complaint, initially filed with the United States District Court for the Southern District of California, alleged AT&T's practice of charging sales tax on a cell phone advertised as free was fraudulent. Several months later, the district court consolidated the Concepcions' case with the *Laster* case, a putative class action, alleging the same claims and issues. Thereafter, and after the WSA was revised to include the premium payment clause, AT&T filed a motion to compel the Concepcions to submit their claims to individual arbitration under the revised arbitration agreement. The district court denied the motion and held that the class waiver provision of the arbitration agreement is unconscionable under California law, and that California unconscionability law is not preempted by the FAA.

Concepcion in the Ninth Circuit

On appeal, a three-judge panel of the Ninth Circuit Court of Appeals affirmed the district court. It led off its opinion by stating that it previously had decided the invalidity of an arbitration agreement banning class actions in *Shroyer v. New Cingular Wireless Services, Inc.*,[17] but noted that AT&T had revised its WSA to include the premium payment discussed above, which was not present in *Shroyer*. Nevertheless, the Ninth Circuit found that the "new wrinkle" presented by the $7,500 premium payment fails to distinguish this case and AT&T's claims that the FAA preempts California unconscionability law was "without merit," and therefore affirmed the district court's order. The court's analysis started with the observation that, to be unenforceable under California law, the contract provision must be procedurally and substantively unconscionable.

California courts follow an unconscionability analysis consisting of a procedural element and a substantive element. The former element focuses on oppression or surprise due to unequal

bargaining power, and the latter on overly harsh or one-sided results. The procedural element of an unconscionable contract usually is in the form of a contract of adhesion.[18] The substantive element stems from inequality of bargaining power. Although adhesive contracts are generally enforced, class action waivers found in such contracts may act effectively as exculpatory clauses[19] that are contrary to public policy.

The Ninth Circuit noted that the California Supreme Court addressed the unconscionability of class action waivers in arbitration provisions for the first time in *Discover Bank*, finding such waivers are "at least sometimes" unconscionable under California law. The *Discover Bank* court set the table by observing that the policy behind class actions—"deterring and redressing wrongdoing, particularly where a company defrauds large numbers of consumers out of individually small sums of money"—is not served by class action waivers that provide no incentive for an individual to bring a solo action to enforce his or her rights and effectively exculpate the wrongdoer.[20]

The Ninth Circuit interpreted the holding in *Discover Bank* to create a three-part test to determine whether a class action waiver in a consumer contract is unconscionable. The test considers: 1) is the agreement a contract of adhesion; 2) are disputes between the parties likely to involve small amounts of damages; and 3) is it alleged that the party with superior bargaining power carried out a plan to deliberately "cheat large numbers of consumers out of individually small sums of money."[21]

The Ninth Circuit in *Concepcion* easily concluded that AT&T's WSA is a contract of adhesion and that the damages alleged are "predictably small," as they were in *Shroyer* and *Discover Bank*. Finally, the court found that the Concepcion complaint allegations of fraudulent advertising were sufficient to meet the third part of the *Discover Bank* test. Because all three parts were satisfied, the Ninth Circuit had little difficulty finding the class action waiver in the AT&T consumer agreement is unconscionable under California law.

However, as explained above, the *Discover Bank* case presented the new wrinkle of a premium payment provision AT&T argued negates the finding that the waiver is substantively unconscionable, because it overcomes any finding under part two of the *Discover Bank* test of predictably small damages. AT&T argued that an award of $7,500 in *its* agreement provides customers an adequate incentive to pursue individually small claims because of the higher potential recovery. The Ninth Circuit brushed this contention aside because the "*Discover Bank* rule focuses on whether damages are predictably small, and in the end, the premium payment provision does not transform a $30.22 case into a predicable $7,500 case." The class action waiver is in effect an exculpatory clause, and hence substantively unconscionable.

Finally, the Ninth Circuit found the saving clause found in Section 2 of the FAA "does not bar federal or state courts from applying generally applicable state contract law principles and refusing to enforce an unconscionable class action waiver in an arbitration clause."[22] Since in California unconscionability is a generally applicable contract defense, under Section 2, it may be applied to invalidate a class action waiver in an arbitration agreement without contravening the FAA.

The court further rejected AT&T's claims that the *Discovery Bank* rule does not follow the sliding scale approach[23] of California general unconscionability law, and is therefore a "new rule" applicable only to arbitration agreements, explaining that the rule announced in *Discovery Bank* is simply a refinement of the general unconscionability analysis to the context of class action waivers.

Moreover, the Ninth Circuit held the FAA does not impliedly preempt California unconscionability law because that law does not stand in the way of the twin purposes of the FAA: 1) to reverse judicial hostility to arbitration agreements by putting them on the same footing as contracts generally; and 2) to promote the efficient and expeditious resolution of claims.[24]

Concepcion at the Supreme Court

AT&T filed a petition for a *writ of certiorari*, which was granted by the Supreme Court. The arguments of both parties in their briefs largely tracked positions they had taken below. In its brief, AT&T stressed the "consumer friendly" nature of the arbitration agreement in the WSA and noted not only the potential for the Concepcions to win a $7,500 premium payment, but also the prospect of double attorney's fees if the arbitrator awards them more than AT&T's last settlement offer, a fact that was not discussed by the Ninth Circuit's opinion.

AT&T argues that whatever procedural unconscionability is present, it is slight because of the protection afforded the customer by various "procedural safeguards" extant within the WSA. Therefore, under the *Discover Bank* test, the agreement is at the low end of the spectrum of procedural unconscionability, and according to AT&T, under the sliding scale analysis, the substantive aspect of unconscionability must be greater to support a finding of unconscionability.[25]

AT&T claims the saving provision found in Section 2 of the FAA does not save California's unconscionability doctrine from preemption since it was applied in a discriminatory fashion to disfavor arbitration in violation of the FAA, because under California's rule there is no resemblance to traditional unconscionability principles that apply

to contracts generally, and constitutes a special legal rule applicable only to arbitration agreements. Because the parties below agreed that the Concepcions could obtain full relief under AT&T's arbitration provision, it was fair to them nonetheless, and the Court invalidated the arbitration provision because of perceived impacts of the requirement of bilateral arbitration on *non-parties*. Thus, AT&T argued, contrary to the Ninth Circuit's claim, that is a new rule, not a mere refinement of traditional unconscionability analysis.

In their responding brief, the Concepcions observed that from reading AT&T's brief one would conclude that California had "struck out on its own in its approach to the enforceability of class-action bans when '[i]n fact courts applying the general contract law of at least 20 States have held that provisions purporting to bar consumers or employers from pursuing class wide relief in any forum may be unenforceable.'" It argues that even if fidelity of these courts to state common law principles were relevant to the issue of FAA preemption, "it would be an unprecedented incursion on State sovereignty for this Court to conclude that so many States have been untrue to their own law." Moreover, far from ignoring their law, the respondents asserted these states were just following their own law because class action bans are unenforceable under general principles of contract law regardless of whether they are embedded in arbitration agreements.

The respondents chose not to directly address AT&T's sliding scale analysis, presumably content to rely upon their discussion of the claimed substantive unconscionability of the arbitration agreement, notwithstanding AT&T's assertion that the agreement's procedural unconscionability is, at best, "slight."

Finally, the Concepcions stressed that nothing in the common law requires courts to limit their analysis of contracts to the two parties and considerations of class-wide or societal effects of private contracts fall within the FAA saving clause.

Conclusion

The U.S. Supreme Court stands at a crossroads, with the parties warning of drastically different consequences from any decision adverse to them. AT&T, speaking for businesses entering into contracts with millions of consumers, claims that if allowed to stand, "the Ninth Circuit decision applying California law will be the death knell for consumer arbitration," at least in California. The Concepcions, speaking for consumers, claim that a ruling adverse to them and in favor of AT&T would preclude courts from policing businesses' worst abuses and "lead to the destruction of public confidence in arbitration as a legitimate and fair means of dispute resolution."

Although oral argument was spirited, it was also unenlightening regarding how the justices might decide, but concerns about federalism may tip the scale. Justice Anton Scalia summarized his concern rhetorically: "Are we going to tell the state of California what it has to consider unconscionable?" The justices have a lot on their minds. ⚖

Endnotes

1. 9 U.S.C. §1 *et. seq*.
2. *Laster v. AT&T Mobility LLC*, 584 F.3d 849 (9th Cir. 2009).
3. *Concepcion v. AT&T Mobility LLC*, 584 F.3d 849 (2009).
4. *Muhammed v. County Bank of Rehoboth Beach, Delaware*, 189 N.J. 1 (2006).
5. *Homa v. American Express Co.,* 558 F.3d 225 (3d Cir. 2009).
6. *Discover Bank v. Superior Court of Los Angeles*, 36 Cal. 4th 148 (2005).
7. "Class Discipline: The Supreme Court Could Change the Face of Class Action Law," *The Economist*, Jan. 27, 2011.
8. 43 Stat. 833. *Stolt-Nielsen v. Animal Feeds International Court*, 130 S. Ct. 1258 (2010).
9. 9 U.S.C. §4.
10. 9 U.S.C. §3.
11. *See* 61 Stat. 669 (1947).
12. 9 U.S.C. §2.
13. *Id*.
14. *Perry v. Thomas,* 482 U.S. 483, 492 n.9 (1987).
15. *Trippe Mfg. Co. v. Niles Audio Corp*., 401 F.3d 529, 532 (3d. Cir. 2005).
16. Specifically, the WSA provides for a payment in the amount of "the maximum claim that may be brought in small claims court in the county of your billing address," which in California is $7,500. Cal. Code Civ. Proc. § 116.221.
17. *Shroyer v. New Cingular Wireless Services, Inc*., 498 A.3d 976 (9th Cir. 2007).
18. Under California law, and many other states, a contract of adhesion is drafted by the party with superior bargaining strength, relegating the subscribing party only the opportunity to adhere to the contract or reject it.
19. An exculpatory clause is part of an agreement which relieves one party from liability. It is a provision in a contract which is intended to protect one party from being sued for their wrongdoing or negligence.
20. *Concepcion*, 584 F.3d at 854.
21. *Id*.
22. *Shroyer*, 498 F.3d at 987.
23. Whereby, elements of both procedural and substantive unconscionability must be present.
24. *Shroyer*, 498 F.3d at 988.
25. The sliding scale approach to unconscionability requires, if "the procedural unconstitutionality, although extant, [is] not great, "the party challenging the provisions must prove "a greater degree of substantive unfairness." *Marin Storage & Trucking, Inc. v. Benco Contracting &*

Eng'g, Inc. 89, Cal.App.4th 1042, 1056 (2001).

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