The Tension Between Opposites in Supreme Court Arbitration Decisions

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I. INTRODUCTION

In the spring of 2011, the Supreme Court in *AT&T Mobility v. Concepcion* handed down what appears to be the beginning of the end of class actions in consumer contract disputes.[1] *Concepcion* addressed the collision between one principle in arbitration (freedom of choice) with another (protection of consumers), and chose freedom of choice.

Although *Concepcion*, at first glance, appears to doom consumer-contract class actions, the consequence of *Concepcion* might be more limited. At its core, *Concepcion* rewards companies that offer arbitration terms so favorable to consumers that a court could not sensibly construe the terms as "unconscionable."[2]

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1. 131 S. Ct. 1740 (2011).
2. *Id*. at 1747.

Concepcion's reliance on freedom of choice may also have wider ramifications for the interface between the Federal Arbitration Act (FAA) and state arbitration statutes, as shown in two recent decisions by the Texas and California supreme courts.

II. AT&T MOBILITY V. CONCEPCION

In *Concepcion*, the Supreme Court held that state contract defenses, as they apply to arbitration agreements, are preempted where they stand as an obstacle to the objectives of Congress in passing the FAA.[3] The Court entered a traditional 5-4 decision: Justice Kennedy sided with the conservatives and Justice Breyer wrote the dissent.[4]

The Concepcions had entered into a sales and service contract with AT&T that included a free phone. But, after making this deal, they were assessed a $30.22 sales tax, for which the Concepcions sued.[5] The contract provided for arbitration and waiver of class actions. But, importantly, the arbitration provision was designed to be very favorable to the consumer: if the consumer won in arbitration, the agreement provided a recovery penalty of $7,500 and two-times the consumer's attorney's fees.[6]

The Court's decision focused on the application of a state contract defense—unconscionability—through § 2 of the FAA.[7] Section 2 of the FAA states that arbitration agreements may be declared unenforceable "upon such grounds as exist at law or in equity for the revocation of any contract."[8] Section 2 has been interpreted to mean that arbitration agreements can be invalidated by "generally applicable contract defenses, such as fraud, duress, and unconscionability."[9]

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3. *See id.* at 1750–53 (holding that California's *Discover Bank* rule, applying unconscionability to defeat an arbitration agreement, was preempted by the purpose of the FAA).
4. *Id.*
5. *Id.* at 1744 (alleging false advertising and fraud causes of action).
6. AT&T Mobility v. Concepcion, 131 S. Ct. 1740, 1744 (2011).
7. *Id.* at 1745–46.
8. 9 U.S.C. § 2 (2006).
9. *See Concepcion*, 131 S. Ct. at 1746 ("[Section 2] 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 that derive their meaning from the fact that an agreement to arbitrate is at issue.").

The trial court held that the arbitration provision, which required arbitration for dispute resolution but prohibited class arbitration, was "unconscionable" under California law.[10] Under California Supreme Court precedent from *Discover Bank v. Superior Court*, AT&T had not shown that bilateral arbitration adequately substituted for the deterrent effects of class actions; the trial court ruled that a "class action waiver provision may 'serve[ ] as a disincentive for [a party with superior bargaining power] to avoid the type of conduct that might lead to class action litigation in the first place.'"[11]

A. Discover Bank v. Superior Court

In *Discover Bank*, the California Supreme Court held that in certain circumstances class-action waivers are unconscionable, and hence invalid.[12] These circumstances are where (1) "a consumer contract of adhesion," (2) "involving predictably small amounts of damages," and (3) "the party with greater bargaining power is alleged to have carried out a scheme to deliberately cheat a large number of consumers out of small sums of money."[13]

The California Supreme Court's reasoning was that, in such cases, the class action waiver effectively exempts the party from responsibility for its own fraud or willful injury to others.[14] The California Court explained this effective license to injure:

> By imposing [the waiver-of-class-actions] clause on its customers, Discover has essentially granted itself a license to push the boundaries of good business practices to their furthest limits, fully aware that relatively few, if any, customers will seek legal remedies, and that any remedies obtained will only pertain to that single customer without collateral estoppel effect.[15]

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10. Laster v. T-Mobile USA, Inc., No. 05-cv-1167 DMS, 2008 U.S. Dist. LEXIS 103712, at *42–43 (S.D. Cal. Aug. 11, 2008).
11. *Id*. at 41 ("[T]he Court's inquiry necessarily is focused on whether the arbitration provision is an adequate substitute for the deterrent effect of the class action mechanism.").
12. *Discover Bank v. Superior Court*, 113 P.3d 1100, 1110 (Cal. 2005), *overruled as applied in AT&T Mobility v. Concepcion*, 131 S. Ct. 1740, 1750–53 (2011).
13. *Id*.
14. *Id*. at 1110.
15. *Id*. at 1108.

By eliminating this potential, dubious "license," the California Court showed that it simply did not want class actions and their policing benefits to be gutted.[16]

B. Ninth Circuit Court of Appeals in **Concepcion**

In its review, the Ninth Circuit upheld the *Discover Bank* rule, applying it to the Concepcions' claim through § 2 of the FAA because the Rule was simply a "refinement" of the unconscionability analysis applicable to contracts generally in California—it was not discriminatorily applied to only arbitration agreements.[17]

The Ninth Circuit explained that under California law, to be unenforceable, "a contract provision must be both procedurally and substantively unconscionable."[18] "Procedural unconscionability generally takes the form of a contract of adhesion," while "[s]ubstantive unconscionability focuses on overly harsh or one-sided contract terms."[19] But both "elements of unconscionability need not be present to the same degree"; instead, California courts use a sliding-scale: "the more substantively unconscionable the contract term, the less procedurally unconscionable it need be to be unenforceable and vice versa."[20] The Ninth Circuit applied the *Discover Bank* rule, holding that the arbitration provision met each element (an adhesion contract, with one-sided terms, where the party with greater bargaining power was accused of a scheme to deliberately cheat consumers out of small amounts of damages), thereby invalidating the arbitration provision for unconscionability.[21]

C. **Concepcion** *in the United States Supreme Court*

Disagreeing with both the trial court and the Ninth Circuit, the Supreme Court held that the parties' right to choose a streamlined arbitration—a cheaper and less burdensome alternative to litigation in court—is more important than the concern about the loss of a class action remedy.[22]

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16. *See id*. at 1108–10.
17. Laster v. AT&T Mobility, 584 F.3d 849, 857 (9th Cir. 2009).
18. *Id*. at 853 (citing Shroyer v. New Cingular Wireless Servs., Inc., 498 F.3d 976, 981 (9th Cir. 2007).
19. *Id*.
20. *Id*.
21. *Id*. at 855.
22. AT&T Mobility v. Concepcion, 131 S. Ct. 1740, 1750–52 (2011).

The Court held that the *Discover Bank* rule is preempted by the FAA because the *Discover Bank* rule "stands as an obstacle to the accomplishment and execution of the full purposes and objectives of Congress," citing three supporting reasons.[23]

First, the switch from bilateral to class arbitration sacrifices the "principle advantage of arbitration": its informality, speed, and lower cost.[24] The Court pointed out that, as of September 2009, the American Arbitration Association (AAA) had opened 283 class arbitrations.[25] Of those, 121 remained active; 162 had been settled, withdrawn, or dismissed; but not a single one had resulted in a final award on the merits.[26] Thus, these numbers indicate that class arbitration is not speedy whatsoever, disposing of arbitration's principal advantage.

Second, class arbitration, by its nature, requires procedural formality, which creates problems when absent parties are bound by the arbitration's results without notice, an opportunity to be heard, or a chance to opt out.[27] When it passed the FAA in 1925, Congress never intended, much less considered, the possibility of class arbitration and its requisite formality.[28] Even *Discover Bank* had admitted that class arbitration was a "relatively recent development."[29]

Third, "class arbitration greatly increases risks to defendants"—the risk of error for "tens of thousands of potential claimants" will often become unacceptable, given the limited grounds for judicial review of the award under *Hall Street*.[30] "Arbitration is poorly suited to the higher stakes of class litigation. In litigation, a defendant may appeal a certification decision on an interlocutory basis and, if unsuccessful, may appeal from a final judgment as well."[31] The grounds for review of an

23. *Id.* at 1751–53.
24. *Id.* at 1751.
25. *Id.* (citing Analysis of the American Arbitration Association's Consumer Arbitration Caseload, Am. Arb. Ass'n., http://www.adr.org/si.asp?id=5027 (last visited Feb. 29, 2012)).
26. *Id.* (citing Brief for Am. Arb. Ass'n. at 22-24, as *Amicus Curiae* in Stolt-Nielsen S.A. v. Animal Feeds Int'l Corp., 130 S. Ct. 1758 (2009) (No. 08-1198)).
27. *Id.* at 1751–52.
28. AT&T Mobility v. Concepcion, 131 S. Ct. 1740, 1751 (2011).
29. Discover Bank v. Superior Court, 113 P.3d 1100, 1110 (Cal. 2005).
30. *Concepcion*, 131 S. Ct. at 1752 (citing Hall Street Assocs., L.L.C. v. Mattel, Inc., 128 S. Ct. 1396 (2008)).
31. *Id.*

arbitration award, however, are significantly more limited.[32] Thus, permitting class arbitration could lead to the "in terrorem" settlements that class actions entail.[33]

The dissent was dismayed. The dissent believed that the FAA's purpose was to enforce arbitration agreements, but consistently with state contract law as § 2 of the FAA permits.[34] The fact that arbitration was often efficient, quick, and less costly was not the overriding purpose of the FAA—its overriding purpose was the *fair* enforcement of the parties' agreement consistent with state law applicable to all contracts.[35] Indeed, the dissent would have upheld the *Discover Bank* unconscionability rule as not preempted, if for no other reason than out of an interest for federalism, as § 2 of the FAA specifically contemplates.[36] In the end, the dissent's point and main frustration was: "What rational lawyer would have signed on to represent the Concepcions in litigation for the possibility of fees stemming from a $30.22 claim?"[37] Answering its own question, the dissent replied: only a "lunatic."[38]

D. At the Least, Concepcion *Rewarded Good Drafting*

Central to the decision were its facts—the parties' contract provided that in addition to any damages awarded, a winning claimant would also receive a penalty-award of $7,500 and two-times attorney's fees.[39] From a common-sense standpoint, it may have been difficult for the majority to even consider an agreement with such favorable terms for the consumer as unconscionable. If the arbitration provision had been rejected by the lower courts as substantively unconscionable—not just against California's (sliding-scale) *Discover Bank* rule regarding

32. *See id.* at 1752.
33. *See id.* (noting the parallel between what might happen in class arbitration if the sort of "in terrorem" settlements that class actions provoke—given the significant risks and high stakes, where defendants are often forced to cut their losses rather than defend against any liability—became an element to consider in every consumer-arbitration agreement).
34. *Id.* at 1757-58.
35. *Concepcion*, 131 S. Ct. at 1760.
36. *Id.* at 1760-61.
37. *Id.* at 1761.
38. *Id.* at 1761 (citing Carnegie v. Household Int'l, Inc., 376 F.3d 656, 661 (7th Cir. 2004) ("The realistic alternative to a class action is not 17 million individual suits, but zero individual suits, as only a lunatic or a fanatic sues for $30.")).
39. AT&T Mobility v. Concepcion, 131 S. Ct. 1740, 1744 (2011).

class-action waivers in consumer contracts—then the result might have been different.

A significant future issue for lower courts will be how favorable to the consumer an arbitration agreement needs to be to eliminate class-action liability. A subsidiary question will be how that issue will differ for other types of contracting parties—vendors, franchisees, or employees—who may be deemed less or more deserving of protection than were the consumers in *Concepcion*.

A recent example testing the scope of *Concepcion*'s holding is a decision from the Second Circuit. In *In re American Express*,[40] the court found a class-action waiver in an arbitration agreement unenforceable by pointing out that the "no-class" clause left plaintiffs unable to pursue their antitrust claims as a class and without any financial possibility of seeking to vindicate their federal statutory rights on an individual basis.[41] The decision points out that the plaintiffs met their burden of showing that their claims could not be realistically pursued on an individual basis under the arbitration agreement.

Going forward, it is unclear how the Supreme Court will deal with such challenges to the scope of its *Concepcion* holding. The path forward, however, does indicate the Court's general favor for upholding arbitration in the face of challenges to limit arbitration's enforceability, as well as plaintiffs' continued challenges to rules favoring arbitration at the expense of making their collective rights worth no more than the paper on which they are written.

III. USING STATE LAW TO CIRCUMVENT SUPREME COURT PRECEDENT

Concepcion was an interpretation of the FAA. But what if an arbitration agreement chooses state arbitration law rather than the FAA as the governing law? The Supreme Court has previously directed parties to the selection of state arbitration law if they wish to avoid the strictures of the FAA.[42] "The FAA is not the only way into court for parties wanting review of arbitration awards: they may contemplate enforcement under state statutory or common law, for example, where judicial review is

40. *In re American Exp. Merchants' Litigation*, 667 F.3d 204, 219 (2d Cir. 2012).
41. *Id.*
42. Hall Street Assocs., L.L.C. v. Mattel, Inc., 128 S. Ct. 1396 (2008).

arguable."[43] Indeed, the "FAA contains no express preemptive provision, nor does it reflect a congressional intent to occupy the entire field of arbitration."[44] Thus, where the parties specifically agree to use state arbitration law, the preemptive nature of the FAA may not apply.[45] If so, the class-action-waiver limitations listed in *Concepcion* could be limited to arbitration agreements applying the FAA—not applying to those selecting the application of state arbitration law.[46]

Two recent state supreme court decisions have addressed the U.S. Supreme Court's decision in *Hall Street*, which held that the grounds for judicial review of an arbitration award are constricted to the four grounds listed in the FAA.[47] These two recent decisions illustrate how the state-law alternative to FAA arbitration could work, but each uses a very different approach.

A. Full Judicial Review via "Exceeded Powers" Ground of Arbitration Act

The Texas Supreme Court arrived at an entirely different result than the U.S. Supreme Court in *Hall Street* by choosing to permit judicial review of arbitral awards under the Texas Arbitration Act (TAA). Instead of holding that the parties could not have full judicial review of an arbitral award, the Texas Court used the agreement's limited grant of powers to the arbitrators to compel the review.[48] In *Nafta Traders, Inc. v. Quinn*, the parties' arbitration agreement expressly stated that the arbitrators did "not have authority to (i) to render a decision which contains a reversible error of state or federal law, or

43. *Id*. at 1406.
44. Volt Info Scis., Inc. v. Bd. of Trustees of the Leland Stanford Junior Univ., 489 U.S. 468, 477 (1988) (citing Bernhardt v. Polygraphic Co., 350 U.S. 198 (1956)).
45. *See* Matthew M. Mitzner, *Snatching Arbitral Freedom from* Hall Street*'s Clenched Fist*, 29 Rev. Litig. 179, 192–95 (2009) (discussing the fact that where state arbitration law is specifically agreed to, the parties have opted out of the FAA, which does not exclusively regulate the field of arbitration pursuant to federal precedent).
46. *See id*. (noting that the FAA is the default set of arbitration rules applied to arbitration agreements in the United States because the agreement must merely "involve" interstate commerce to qualify and for the FAA to apply with preemptive effect where the parties did not specifically opt out).
47. *Hall Street*, 128 S. Ct. at 1404–06.
48. Nafta Traders, Inc. v. Quinn, 339 S.W.3d 84, 88 (Tex. 2011), *cert. denied*, 132 S. Ct. 455 (2011).

(ii) to apply a cause of action or remedy not expressly provided for under existing state or federal law."[49]

The Texas Supreme Court held that the arbitrators were limited by the parties' grant of powers and hence would be subject to vacatur through the "exceeded their powers" clause in the Texas Arbitration Act.[50] Directly opposing the U.S. Supreme Court's construction of the FAA's very same exceeded-their-powers ground, the Texas Supreme Court explained its differing conclusion:

> When parties have agreed that an arbitrator should not have authority to reach a decision based on reversible error—in other words, that an arbitrator should have no more power than a judge—a motion to vacate for such error as exceeding the arbitrator's authority is firmly grounded in the text of section 10 [of the FAA]. The Supreme Court's reasoning that an arbitrator's merely legal errors are not the kind of "egregious departures from the parties' agreed-upon arbitration" [that] section 10 addresses loses force when such errors directly contradict the parties' express agreement and deprive them of the benefit of their reasonable expectations.[51]

This Texas Supreme Court holding is ingenious. The principle of freedom of choice (which has been given priority in U.S. Supreme Court decisions) is used to avoid the FAA's statutory prohibition of full judicial review. The TAA is interpreted to uphold the parties' contractual limitation of the arbitrators' powers, thereby legitimizing full judicial review.

B. Judicial Review of Arbitral Awards as a Matter of Public Policy

The California Supreme Court took a different route to upholding full judicial review under California state law. In *Pearson Dental Supplies, Inc. v. The Superior Court of Los Angeles County*, the California Supreme Court held that for an arbitration agreement expressly using the California Arbitration Act (CAA) as the governing law, judicial review of the arbitral award was permitted to protect an employee's unwaivable stat-

49. *Id.*
50. *Id.* at 93–94.
51. *Id.* at 92–93.

utory rights (regardless of the fact that the agreement had no clause limiting the arbitrators' powers).[52] This decision means that a court reviewing the arbitration award could vacate where the arbitrators merely made a mistake of law that did not even rise to the level of "exceeding their powers"—reaching beyond the holding in *Nafta Traders*.[53]

In *Pearson*, the arbitrator made an error of law in applying the statute of limitations.[54] This error was subject to vacatur under the California Code of Civil Procedure because the Code permitted arbitration in this employment context only where the employee was able to vindicate his or her rights.[55] Here, because of the arbitrator's mistake, the California Court held that the employee was not able to so vindicate his rights.[56] The majority explained its reasoning for permitting judicial review of the arbitral award:

> [C]onstruing the CAA in light of the legislature's intent that employees be able to enforce their right to be free of unlawful discrimination under [the California Fair Employment and Housing Act], an arbitrator whose legal error has barred an employee subject to a mandatory arbitration agreement from obtaining a hearing on the merits of a claim based on such right has exceeded his or her powers within the meaning of [the California Code of Civil Procedure governing arbitration], and the arbitrator's award may properly be vacated.[57]

The dissent argued that the contract here had no limiting clause on the arbitrators' powers, so permitting judicial review would be a dramatic expansion of judicial review of arbitration.[58] This is what the majority in *Hall Street* sought to

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52. 229 P.3d 83, 92–93 (Cal. 2010).

53. *Cf. id.*; *see* Hall Street Assocs., L.L.C. v. Mattel, Inc., 128 S. Ct. 1396, 1404-06 (2008) (eliminating judicial review of an arbitral award outside of the four listed grounds in the FAA's Section 10(a)).

54. *Pearson Dental Supplies, Inc.*, 229 P.3d at 87–88.

55. *Id.*

56. *Id.* at 89.

57. *Id.* at 93.

58. Pearson Dental Supplies, Inc. v. The Superior Court of Los Angeles Cnty., 229 P.3d 83, 98–99 (Cal. 2010).

avoid.[59] The dissent argued that this exception would open a floodgate:

> It is well settled that "arbitrators do not exceed their powers merely because they assign an erroneous reason for their decision." A contrary holding would permit the exception to swallow the rule of limited judicial review; a litigant could always contend the arbitrator erred and thus exceeded his powers.[60]

In the end, what the dissent found "most troubling" was that the majority's decision was "irreconcilable with the fundamental premise that the risk of arbitral error is what contracting parties bargain for in exchange for a quick, inexpensive, and conclusive resolution to their dispute."[61] The dissent simply did not want the courts "second-guessing" the legal or equitable basis for the arbitral award.[62]

What *Pearson* shows is that state arbitration law can not only differ on procedural grounds, but may also fully oppose substantive federal arbitration policy as set forth by Congress and determined by the U.S. Supreme Court. The U.S. Supreme Court's earlier decision in *Volt*—which permitted the application of state-arbitration law contrary to the FAA because the FAA does not occupy the entire field—appears essential to *Pearson*'s ability to withstand Supreme Court review.[63] Otherwise, *Pearson* would appear to merely raise a fairness issue in the employment context similar to the *Discover Bank* rule of fairness for consumers, which was rejected by the U.S. Supreme Court in *Concepcion*.

IV. WAYS OF ADJUSTING FOR CONCEPCION'S *LIMITATIONS*

Nafta Traders and *Pearson* illustrate two ways to control arbitrators' actions. One is by controlling the scope of authority that the arbitrators are initially given in the arbitration agreement, just as the parties did in *Nafta Traders* (eliminating deci-

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59. *Id*.
60. *Id*. at 96 (quoting Moncharsh v. Heily & Blasé, 832 P.2d 899, 916 (Cal. 1992)).
61. *Id*. at 99.
62. *Id*.
63. Volt Info Scis., Inc. v. Bd. of Trustees of the Leland Stanford Junior Univ., 489 U.S. 468, 477 (1988).

sions with reversible error under state or federal law or applying a cause of action or remedy not expressly provided for under existing state or federal law).[64] This controlled scope of authority is what you might think of as a "front-end control." This front-end concept finds support in the principle that arbitration is a creature of contract—the principle used to great effect by the majority upholding the class-action waiver in *Concepcion*.

Another way to control arbitrators is to provide for judicial review of an arbitral decision after the award is made. The Supreme Court's *Hall Street* decision greatly limited the ability of parties to vary judicial review from the grounds set forth in the FAA. But *Hall Street* was based on a contract stipulated to be subject to the FAA; in the opinion, the Court specifically suggests that state arbitration law may offer expanded judicial review. Now, the California Supreme Court in *Pearson* suggests that making state arbitration law the governing law of the agreement can allow for later "back-end" control through fuller, substantive judicial review.

The use of both the front-end and back-end approaches could operate as a belt-and-suspenders method of ensuring judicial review.

The next few years may see a succession of cases exploring the tension between the FAA's policy of freedom of contract and state (and other federal) policies protecting classes of citizens in need of special protection of their rights. As a result, this may turn out to be a formative period in the law of arbitration.

64. *See* Mitzner, *supra* note 46, at 206–10.