Legal Backgrounder

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STATE HIGH COURT CONDEMNS ARBITRATION PROVISIONS THAT DON'T ALLOW CLASS ACTIONS

By

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Congress enacted the Federal Arbitration Act (FAA) eight decades ago to eliminate longstanding judicial hostility to the private resolution of disputes through arbitration. The United States Supreme Court has emphasized that the FAA embodies a strong federal policy favoring arbitration, and confirmed more than twenty years ago that the FAA preempts contrary state law. In reliance on the Court's endorsement of this speedy, fair, and inexpensive method of resolving disputes, American businesses have routinely included arbitration provisions in their standard consumer agreements.

These arbitration provisions often preclude class actions or arbitrations. Such a limitation, most businesses believe, is essential to preserve the "simplicity, informality, and expedition of arbitration." *Mitsubishi Motors Corp. v. Soler Chrysler-Plymouth, Inc.*, 473 U.S. 614, 628 (1985). In accordance with this understanding, the overwhelming majority of federal and state courts faced with the issue have enforced class-action waivers.

Discover Bank v. Superior Court: The California Supreme Court Strikes Down Most Class-Action Waivers in Consumer Contracts

The California Supreme Court followed a different (and decidedly minority) path in *Discover Bank v. Superior Court*, 113 P.3d 1100 (Cal. 2005), holding, by a 4-3 vote, that at least "some" class-action waivers in consumer arbitration provisions are "unconscionable" as a matter of California contract law.

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The plaintiff in *Discover Bank* filed a class-action lawsuit against his credit-card company, alleging that certain details in the imposition of a $29 late fee constituted a deceptive practice. *Id*. at 1104. After initially applying the card agreement's Delaware choice-of-law provision and compelling arbitration, the trial court reconsidered its decision in light of an intervening appellate decision and held that it would violate California public policy to enforce the class-action waiver. The intermediate court of appeal overturned that decision, holding that the FAA preempted any California rule that prohibited class-action waivers in arbitration provisions. *See id*. at 1105.

The California Supreme Court reversed. Despite growing concerns about the potentially abusive nature of class action litigation—recently expressed by Congress when it passed the Class Action Fairness Act—the court began its analysis by extolling the virtues of class litigation. *Id*. at 1105-1106. In the court's view, class actions are "often the only effective way to halt and redress . . . exploitation." *Id*. at 1105 (citations omitted). The court concluded that "at least some class action waivers in consumer contracts are unconscionable under California law" because they "may operate effectively as exculpatory contract clauses that are contrary to public policy." *Id.* at 1108.

The court rejected the holdings of several other courts that had approved a number of mechanisms that ensure that class-action waivers do not exempt defendants from liability. These include the availability of attorneys' fees under fee-shifting statutes, open access to small claims court as an alternative forum, and the ability of government officials to undertake enforcement actions. *See id*. at 1109-1110. Instead, the court announced a new test for evaluating whether class-arbitration provisions are unconscionable. *Id*. at 1110 (citation omitted):

> [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.

This novel holding departs from the traditional understanding of the unconscionability doctrine: that it is reserved to provide relief for often unsophisticated individuals who have been effectively coerced into entering contracts characterized by extreme unfairness—unless, of course, one starts from the premise, contrary to the policies animating the FAA, that individual arbitration is extremely unfair.

The *Discover Bank* court also held that the Federal Arbitration Act did not preempt the application of this new unconscionability holding. The court denied that its "rule against class action waivers" violated the FAA. *Id.* at 1113. In the court's narrow view, the FAA "forbids" only "the use of" unconscionability and other defenses to contract enforcement "to discriminate against arbitration clauses." *Id*. Finally, the court was not swayed by the argument that superimposing class procedures as a condition of enforcing arbitration agreements is inherently incompatible with the purpose of the FAA. *Id.* at 1113-1117. It remanded for the lower courts to determine whether California's fundamental public policy would bar application of Delaware law (under which class-action waivers are generally enforceable). *Id*. at 1117-1118. (On remand,

the intermediate court of appeal applied Delaware law and enforced the class waiver. 36 Cal. Rptr. 3d 456, 459-462 (Cal. Ct. App. 2005). Plaintiffs have sought review by the California Supreme Court.)

The Effect of *Discover Bank*

Discover Bank represents a troublesome expansion of California unconscionability law in disregard of contrary federal policies, in a decision that falls squarely in line with prior California decisions evincing both hostility to arbitration and a narrow view of FAA preemptions. See *Southland Corp. v. Keating*, 465 U.S. 1 (1984) (reversing California decision upholding statutory limit on arbitration); *Perry v. Thomas*, 482 U.S. 483 (1987) (same). The California Supreme Court's holding that class-arbitration waivers are not enforceable in "some circumstances" conflicts with the strong federal policy favoring the enforcement of arbitration provisions as they are written. As Judge Easterbrook has explained, "The cry of 'unconscionable!' just repackages the tired assertion that arbitration should be disparaged as second-class adjudication. It is precisely to still such cries that the Federal Arbitration Act equates arbitration with other contractual terms." *Carbajal v. H & R Block Tax Servs., Inc.*, 372 F.3d 903, 906 (7th Cir. 2004). The California Supreme Court's decision does not comport with this principle.

To the contrary, if *Discover Bank* is applied broadly to invalidate class-arbitration waivers in all consumer contracts—a result that plaintiffs' lawyers are urging with considerable success upon state and federal courts in California—that will likely mean the end of consumer arbitration in that state. Indeed, state and federal courts in California have already struck down the arbitration provisions of an Internet provider, a credit card issuer, a franchisor, a bank, and wireless service providers under *Discover Bank*. *See, e.g.*, *Parrish v. Cingular Wireless, LLC*, 2005 WL 2420719 (Cal. Ct. App. Oct. 3, 2005), pet. for cert. pending sub nom. *Cingular Wireless LLC v. Mendoza*, No. 05-1119 (filed Mar. 3, 2006); *Aral v. Earthlink, Inc.*, 36 Cal. Rptr. 3d 229 (Cal. Ct. App. 2005); *Klussman v. Cross Country Bank*, 36 Cal. Rptr. 3d 728 (Cal. Ct. App. 2005); *Indep. Ass'n of Mailbox Ctr. Owners, Inc. v. Super. Ct.*, 34 Cal. Rptr. 3d 659 (Cal. Ct. App. 2005); *Tamayo v. Brainstorm USA*, 2005 WL 2293493 (9th Cir. Sept. 21, 2005); *Laster v. T-Mobile USA, Inc.*, 407 F. Supp. 2d 1181 (S.D. Cal. 2005). *But see, e.g.*, *Jones v. Citigroup, Inc.*, 38 Cal. Rptr. 3d 461 (Cal. Ct. App. 2006) (upholding class-arbitration waiver in cardholder agreement); *Provencher v. Dell, Inc.*, 409 F. Supp. 2d 1196 (C.D. Cal. 2006) (distinguishing *Discover Bank* and applying Texas law to uphold class-arbitration waiver).

In light of this trend of interpreting *Discover Bank* as an absolute bar on class-arbitration waivers, very few companies that do business in California are likely to be willing to include arbitration provisions in their contracts because of the risk of being forced into class arbitration by a court that decided that a class-arbitration waiver was severable. Because extensive procedures are necessary to the fair administration of a class action, class-wide arbitration will be more expensive and more time consuming than individual arbitration—and, in the process, will eradicate the distinction between arbitration and litigation. Even more troublesome, class arbitration presents businesses with the worst of both worlds. While the stakes in a class arbitration would be exponentially higher than those in an individual arbitration, any class-wide arbitral award (like other arbitral awards) would be reviewable only for fraud, bias, or "manifest disregard" of the law. *Wilko v. Swan*, 346 U.S. 427, 436-437 (1953) (construing 9 U.S.C. § 10), overruled on other grounds by *Rodriguez de Quijas v. Shearson/Am. Express, Inc*, 490 U.S. 477 (1989). In such circumstances, few

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businesses would be willing to roll the dice by including an arbitration provision in their consumer contracts.

Ultimately, *Discover Bank*'s effect will be to increase the costs of goods and services for Californians. "[A]rbitration offers cost-saving benefits . . . [that] are reflected in a lower cost of doing business . . . passed along to customers." *Boomer v. AT&T Corp.*, 309 F.3d 404, 419 n.7 (7th Cir. 2002) (citations and internal quotation marks omitted). By discouraging the use of arbitration provisions, the decision in *Discover Bank* ensures that companies will face the costs of class litigation; that burden likely will translate into higher prices for consumers.

* * * * *

As noted above, *Discover Bank* is part of a continuing pattern in which the California Supreme Court has fallen out of step with mainstream jurisprudence on private agreements to choose a forum for dispute resolution. Even after the U.S. Supreme Court's decisions in *Southland* and *Perry*, the California court has disregarded the FAA and the Supremacy Clause in holding that claims for so-called "public" injunctive relief under two state statutes (the Consumers Legal Remedies Act and the wide-ranging Unfair Competition Law) are inarbitrable, even when brought by private parties and their lawyers, because state remedial policies conflict with the use of the arbitral forum. *See Cruz v. PacifiCare Health Systems, Inc.*, 66 P.3d 1157 (Cal. 2003); *Broughton v. Cigna Healthplans*, 988 P.2d 67 (Cal. 1999). That decision was made in the face of language in U.S. Supreme Court cases explaining that only Congress could declare a statute inarbitrable, and ignored the fact that Congress has never exercised that power for the benefit of state laws. The California Supreme Court has further demonstrated its unwillingness to enforce contracts addressing dispute resolution by holding that pre-dispute contractual waivers of jury trials are invalid—except for those contained in arbitration provisions (which it has already undercut). *See Grafton Partners L.P. v. Superior Court*, 116 P.3d 479 (Cal. 2005). Thus, California is particularly unreceptive to businesses' efforts to restrain litigation costs—even though those efforts may be routinely upheld in other states.

Conclusion

In the 1980s, the U.S. Supreme Court twice had to remind the California Supreme Court that the Federal Arbitration Act preempts state law to the contrary. In *Discover Bank*, California has once again strayed from the FAA's command that arbitration agreements should not be treated with hostility and suspicion, but instead must be placed on an equal footing with other contracts. Once again, the U.S. Supreme Court's intervention is needed to ensure that California courts will enforce contractual arbitration provisions in accordance with their terms. The authors have recently filed a petition for certiorari in the *Mendoza* case noted above (U.S. No. 05-1119), asking the Court to decide whether the FAA preempts California's rule conditioning the enforceability of an arbitration agreement on a defendant's amenability to class arbitration. In the meantime, businesses should be aware of the peculiar challenges to ensuring meaningful dispute resolution alternatives in California.

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