Washington Legal Foundation

December 11, 2015

On the Merits:

MHN GOVERNMENT SERVICES, INC. AND
MANAGED HEALTH NETWORK, INC.,

Petitioners,

v.

THOMAS ZABOROWSKI, ET AL.,

Respondents.

No. 14-1458

U.S. Supreme Court

Question Presented: Whether California's arbitration-only severability rule, which treats arbitration contracts differently from other contracts when determining whether all or only part of an arbitration agreement is void under state law, is preempted by the Federal Arbitration Act.

Summary of the Case: Petitioners are military contractors who provide military-service members and their families with a network of licensed consultants offering medical, financial, child services, and victim advocacy counseling at U.S. military installations worldwide. Respondents are consultants who are members of petitioners' network. Upon joining petitioners' network, respondents reviewed and signed a Provider Services Task Order Agreement that contained a mandatory arbitration clause. The Agreement also contained a severability clause specifying that if "any provision of this Agreement is rendered invalid or unenforceable … the remaining provisions of this Agreement shall remain in full force and effect." Despite having agreed to arbitrate any dispute, respondents filed a putative collective action and class-action lawsuit against petitioners in federal district court alleging violations of the wage-and-hour provisions of the Fair Labor Standards Act and state law.

Petitioners moved to compel arbitration, but the district court denied the motion finding, under California law, that several of the provisions of the arbitration clause were unconscionable. A divided Ninth Circuit panel affirmed the district court's ruling, holding that the provisions of the arbitration clause relating to arbitrator selection, the six-month statute of limitations, the arbitration filing fee, prevailing party fee-shifting, and the punitive-damages bar were all unconscionable under California law. Ignoring the Agreement's severability clause, the Ninth Circuit held that the multiple offending provisions were not severable under California law because they "permeate[d] the entire agreement with unconscionability."

On the Merits:
Judgment for Petitioner
John F. Querio
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The Federal Arbitration Act (FAA) provides that "A written provision in any maritime transaction or a contract evidencing a transaction involving commerce to settle by arbitration a controversy thereafter arising out of such contract or transaction … shall be 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. As we have stated innumerable times in the past, this provision embodies a "liberal federal policy favoring arbitration," *Moses H. Cone Mem'l Hosp. v. Mercury Constr. Corp.*, 460 U.S. 1, 24 (1983), and requires that both federal and state courts place arbitration agreements on an equal footing with other contracts and enforce arbitration agreements according to their terms. *See AT&T Mobility LLC v. Concepcion*, 563 U.S. 333, 339 (2011); *Buckeye Check Cashing, Inc. v. Cardegna*, 546 U.S. 440, 443 (2006); *Volt Info. Scis., Inc. v. Bd. of Trs. of Leland Stanford Junior Univ.*, 489 U.S. 468, 478 (1989).

We have interpreted the savings clause of § 2 of the FAA to exempt from preemption generally applicable contract defenses under state law, as long as they are not "defenses that apply only to arbitration or that derive their meaning from the fact that an agreement to arbitrate is at issue." *Concepcion*, 563 U.S. at 339; *see Doctor's Assocs., Inc. v. Casarotto*, 517 U.S. 681, 687 (1996); *Perry v. Thomas*, 482 U.S. 483, 492-93 n.9 (1987). Thus, FAA preemption applies not just "[w]hen state law prohibits outright the arbitration of a particular type of claim," *Concepcion*, 563 U.S. at 341, but also "when a doctrine normally thought to be generally applicable … is alleged to have been applied in a fashion that disfavors arbitration." *Id.* Even in the latter circumstance, state law is preempted where it disproportionately impacts arbitration agreements because "a court may not '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 . . . the state legislature cannot.'" *Id.* (quoting *Perry*, 482 U.S. at 493 n.9).

The question confronting us in this case is whether the severability rule California courts apply to arbitration agreements is preempted under these FAA standards. In *Armendariz v. Foundation Health Psychcare Services, Inc.*, 24 Cal. 4th 83, 124, 6 P.3d 669, 696-97 (2000), the California Supreme Court held that where "an arbitration agreement contains more than one unlawful provision," that inherently "indicate[s] a systematic effort to impose arbitration on an employee not simply as an alternative to litigation, but as an inferior forum that works to the employer's advantage," which allows the court to refuse to sever the unconscionable provisions on the ground that the entire arbitration agreement is "permeated by an unlawful purpose." Ever since *Armendariz*, California courts have applied this arbitration-specific severability rule in a mechanical way to disfavor arbitration agreements. *See, e.g.*, *Fitz v. NCR Corp.*, 118 Cal. App. 4th 702, 726, 13 Cal. Rptr. 3d 88, 106 (2004) ("In *Armendariz* the California Supreme Court held that more than one unlawful provision in an arbitration agreement weighs against severance"; refusing to sever multiple unconscionable arbitration provisions); *Trivedi v. Curexo Tech. Corp.*, 189 Cal. App. 4th 387, 398, 116 Cal. Rptr. 3d 804, 812-13 (2010) (following *Armendariz* in refusing to sever multiple unconscionable provisions in arbitration agreement because that is "a circumstance considered by [the California] Supreme Court to 'permeate' the agreement with unconscionability"); *Pinela v. Neiman Marcus Grp., Inc.*, 238 Cal. App. 4th 227, 256, 190 Cal. Rptr. 3d 159, 183-84 (2015) (while stating severance is appropriate "where only one clause in an arbitration agreement [is] found to be substantively unconscionable," refusing to sever where "multiple provisions" were found unconscionable).

By contrast, California courts have not applied any presumption against severance outside the context of arbitration agreements. Indeed, with non-arbitration contracts, "California cases take a very liberal view of severability, enforcing valid parts of an apparently indivisible contract where the interests of justice or the policy of the law would be furthered." *In re Marriage of Facter*, 212 Cal. App. 4th 967, 987, 152 Cal. Rptr. 3d 79, 95 (2013); *see also Marathon Entm't, Inc. v. Blasi*, 42 Cal. 4th 974, 996-98, 174 P.3d 741, 743-44 (2008) (applying more liberal approach to sever unlawful provisions of non-arbitration contract). The presumption in favor of severance is particularly strong where a contract (like the Agreement here) contains a severability clause, which "evidence[s] the parties' intent that, to the extent possible, the valid provisions of the contracts be given effect, even if some provision is found to be invalid or unlawful." *Facter*, 212 Cal. App. 4th at 985, 152 Cal. Rptr. 3d at 94 (internal quotation marks omitted).

In short, California law applies a de facto presumption against severance to arbitration agreements that contain multiple unconscionable provisions but a de facto presumption in favor of severance to non-arbitration contracts containing multiple unconscionable provisions. California severability doctrine thus disproportionately burdens arbitration agreements and is therefore preempted by the FAA. *See Concepcion*, 563 U.S. at 341. The judgment of the Ninth Circuit is reversed, and the case remanded for further proceedings consistent with this opinion.

Dissenting View:
Deepak Gupta
Gupta Wessler PLLC

The court of appeals correctly held that California's severance doctrine is not preempted by the FAA because the doctrine applies evenhandedly to any type of contract—regardless of whether the contract contains an arbitration clause.

Under the FAA's savings clause, arbitration agreements are valid and enforceable "save upon such grounds as exist in law or in equity for the revocation of any contract." 9 U.S.C. § 2. This provision embodies an "enforceability mandate" under which "State law … is applicable to determine which contracts are binding under Section 2." *Arthur Andersen LLP v. Carlisle*, 129 S. Ct. 1896, 1902 (2009). The FAA does not "alter background principles of contract law. … Indeed, § 2 explicitly retains an external body of law governing revocation (such grounds 'as exist at law or in equity.')." *Id.*

Not all state contract law, however, is saved from preemption by § 2. Because the FAA "places arbitration agreements on an equal footing with other contracts," *Rent-A-Center, West, Inc. v. Jackson*, 130 S. Ct. 2772, 2776 (2010), it only permits arbitration agreements to be "invalidated by *generally applicable* contract defenses, such as fraud, duress, or unconscionability." *Id.* (quoting *Doctor's Assoc., Inc. v. Casarotto*, 517 U.S. 681, 687 (1996) (emphasis added).

California's severance doctrine gives trial courts discretion to decide whether to sever unconscionable provisions from a contract or decline to enforce the entire contract. And, key here, the doctrine is rooted in a generally applicable statute, § 1670.5 of the California Civil Code, which by its terms allows courts that find a contract unconscionable to either (1) "refuse to enforce the contract," or (2) "enforce the remainder of the contract without the unconscionable clause," or (3) "so limit the application of any unconscionable clause as to avoid any unconscionable result." Cal. Civ. Code § 1670.5(a).

The Legislature's comments make clear that the statute was intended to give courts "discretion" to "refuse to enforce the contract as a whole if it is permeated by unconscionability" or to "strike any single clause or group of clauses which are so tainted or which are contrary to the essential purpose of the agreement." Neither the statute's text nor its commentary mandates or contemplates any arbitration-specific approach.

This statute is thus discretionary, generally applicable, arbitration-neutral, and reflective of an approach adopted by many other states under the Uniform Commercial Code. Indeed, the California Supreme Court's decision in *Armendariz*, which explains how lower courts are to exercise their discretion under § 1670.5, draws from a wide array of contracts jurisprudence, most of which does not concern arbitration at all. And the principles announced in *Armendariz* have since been applied to govern severability questions that arise entirely outside the arbitration context. *See, e.g., Marathon Entm't, Inc. v. Blasi*, 42 Cal. 4th 974 (2008). Thus, this discretionary standard has been applied to property-management contracts and contingent-fee agreements, to take just two examples. *See, e.g., MKB Mgmt., Inc. v. Melikian*, 184 Cal. App. 4th 796, 805 (2010); *Shopoff & Cavallo, LLP v. Hyon*, 167 Cal. App. 4th 1489, 1523 (2008).

This general state-law approach is necessarily "fact specific" and discretionary. *Marathon Entm't,* 42 Cal. 4th at 998. As the California Supreme Court has explained in a non-arbitration case: "Inevitably, no verbal formulation can precisely capture the full contours of the range of cases in which severability properly should be applied, or rejected." *Id.* California courts have accordingly exercised their discretion to either sever or not sever illegal contract terms, based on the standard set forth in § 1670.5(a) and *Armendariz*.

California's approach is therefore fully consistent with this Court's cases, including this Court's decision in *AT&T Mobility LLC v. Concepcion*, which reiterates the FAA's "equal footing" principle and thus "permits arbitration agreements to be declared unenforceable upon such grounds as exist at law or in equity for the revocation of any contract." 563 U.S. at 339. To embrace MHN's position, by contrast, would require courts to stray beyond both the "equal footing" principle and the FAA's text, and to second-guess the California Supreme Court's articulation of California state law. That approach would threaten the comity and respect due to sovereign state courts in a federalist system. Section 2 of the FAA preserves an important sphere of state sovereignty and the Court "should be and [is] 'reluctant to federalize' matters traditionally covered by state common law." *Paterson v. McLean Credit Union*, 491 U.S. 164, 183 (1989). Thus, when there is "doubt about [the] existence" of a state-law principle, this Court "do[es] not make [its own] assessment but accept[s] the determination of the state court." *Stop the Beach Renourishment, Inc. v. Florida Dept. of Envt'l Prot*., 130 S. Ct. 2592 (2009) (Scalia, J., plurality opinion).

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