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Client Alert

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The US Supreme Court Holds That the FAA Preempts States From Conditioning the Enforcement of Arbitration Agreements Upon the Availability of Class Arbitration

In a decision issued on April 27, 2011, the United States Supreme Court held that the Federal Arbitration Act (FAA) preempts California's rule prohibiting class action waivers in most consumer arbitration agreements.[1] This decision is a victory for companies across a wide spectrum of industries, as it reaffirms the Courts' preference for enforcing arbitration agreements according to their terms in order to ensure that parties will receive the full benefit of those agreements.

"The Supreme Court's decision in *Concepcion* affirms the strong federal policy favoring arbitration and enforcement of arbitration agreements according to their terms."

Factual and Procedural Background of *AT&T Mobility LLC v. Concepcion*

In 2002, the Concepcions entered into a cellular phone service agreement with AT&T, which had advertised the service as including free phones.[2] When the Concepcions received those phones, AT&T charged them sales tax based upon the phones' retail values.[3] The Concepcions filed a case in the United States District Court for the Southern District of California that was subsequently consolidated with a putative class action involving the same issue, claiming that AT&T had engaged in false advertising and fraud.[4]

AT&T moved to compel arbitration of the Concepcions' claims pursuant to the arbitration agreement in their service contract.[5] The Concepcions opposed the motion, arguing that the arbitration provision was unconscionable and unlawfully exculpatory, because it specifically prohibited class arbitration and was therefore unenforceable under California law.[6] The district court denied AT&T's motion,[7] relying upon the California Supreme Court's decision in *Discover Bank v. Superior Court*, which precludes class action waivers in adhesion contracts when the damages are predictably small and the claim involves allegations of a fraudulent scheme to cheat consumers.[8]

AT&T appealed, and the United States Court of Appeals for the Ninth Circuit affirmed the district court's decision, again relying upon the rule announced in *Discover Bank*.[9] The Ninth Circuit also rejected AT&T's arguments that the *Discover Bank* rule was preempted by the FAA, holding that *Discover Bank* simply represented "a refinement of the unconscionability analysis applicable to contracts generally in California" and was thus a basis in law or equity for the revocation of an agreement as permitted in the FAA.[10]

The Supreme Court Reverses the Ninth Circuit's Decision in *Concepcion* and Holds That the FAA Preempts California's *Discover Bank* Rule

In a 5-to-4 decision that was largely split along ideological lines, the Supreme Court reversed the Ninth Circuit. Writing for the majority, Justice Scalia, joined by Chief Justice Roberts and Justices Alito, Kennedy and Thomas (who also wrote a concurring opinion), rejected the rule articulated by the California Supreme Court in *Discover Bank*.[11] The Court held that "[r]equiring the availability of classwide arbitration interferes with fundamental attributes of arbitration and thus creates a scheme inconsistent with the FAA."[12]

The Court was influenced by the significant differences between bilateral arbitration and class arbitration. Relying upon its fairly recent decision in *Stolt-Nielsen S. A. v. AnimalFeeds Int'l Corp*. (in which the Court refused to interpret an arbitration agreement as allowing class arbitration where the agreement was silent on the issue[13]), the majority stated:

> [T]he switch from bilateral to class arbitration sacrifices the principal advantage to arbitration—its informality—and makes the process slower, more costly, and more likely to generate procedural morass than final judgment.[14]

The majority also noted that class arbitration requires procedural formality and protection for absent parties that arbitrations generally do not require.[15] In light of these fundamental differences, the majority ultimately concluded that "[a]rbitration is poorly suited to the higher stakes of class litigation," and that conditioning enforceability of arbitration agreements upon the requirement of the availability of class arbitration would "not be arbitration as envisioned by the FAA, lacks its benefits, and therefore may not be required by state law."[16] The majority concluded that "States cannot require a procedure that is inconsistent with the FAA, even if it is undesirable for unrelated reasons."[17]

The Court also rejected the argument embraced by the Ninth Circuit that the *Discover Bank* rule was permissible because it went beyond just arbitration agreements and prohibited class waivers in *all* agreements.[18] The Court held that even a rule that is facially of general application may be subject to preemption when it "is alleged to have been applied in a fashion that disfavors arbitration," so that it would have, in practice, a "disproportionate impact on arbitration agreements."[19] And, in this case, conditioning the enforceability of arbitration agreements upon the availability of class arbitration would fundamentally alter the nature of arbitration and thus interfere with the FAA.[20]

The Court's decision does envision that states may properly address concerns regarding contracts of adhesion and impose protections for consumers relating to such contracts (for example, by requiring waiver language to be highlighted). "Such steps cannot, however, conflict with the FAA or frustrate its purpose to ensure that private arbitration agreements are enforced according to their terms."[21]

While the rule ostensibly only burdened adhesion contracts, the majority found that of no consequence because "the times in which consumer contracts were anything other than adhesive are long past." And the majority found the rule's limitation to small dollar-value claims involving allegations of fraud was also unpersuasive because the limitations were "toothless" and easily circumvented.[22] Ultimately, the Court concluded that these conditions had little effect other than to chill bilateral arbitration of claims.[23]

It is important to note, however, that arbitration agreements generally remain subject to challenge on the grounds of unconscionability, in spite of *Concepcion*. Thus, courts may still declare an arbitration agreement void on the grounds of unconscionability (including an arbitration agreement with a class action waiver) if the party challenging that agreement can demonstrate that it is both procedurally and substantively unconscionable in accordance with the applicable state's laws.[24]

Conclusion

The Supreme Court's decision in *Concepcion* affirms the strong federal policy favoring arbitration and enforcement of arbitration agreements according to their terms. Given the Court's clear holding preempting state rules against class action waivers in arbitration agreements, companies should carefully consider integrating into their purchase, sales and employment agreements arbitration clauses that contain a waiver of class action proceedings.

Endnotes

[1] *See AT&T Mobility LLC v. Concepcion*, Case No. 09-893, 563 U.S. ____ (April 27, 2011).

[2] *See id.*, Slip Op. at 1-2.

[3] *See id.* at 3.

[4] *See id.*

[5] *See id.*

[6] *See id.*

[7] The District Court denied AT&T's motion, even though it noted that an individual consumer's success in arbitration with AT&T would likely lead to full or even excess payment to the consumer and that the Concepcions would likely fair worse as members of a class. *See id.*

[8] *See id.* at 5-6, 12; *see also Discover Bank v. Superior Court*, 36 Cal. 4th 148, 162-63 (2005) ("[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.") (internal quotations and citation omitted).

[9] *See Concepcion*, Slip Op. at 3-4.

[10] *See id.* at 4.

[11] *See id.* at 5-18.

[12] *See id.* at 9.

[13] *See Stolt-Nielsen S. A. v. AnimalFeeds Int'l Corp.*, 130 S. Ct. 1758, 1773-76 (2010).

[14] *See Concepcion*, Slip Op. at 14.

[15] *See id.* at 15 ("[I]t is at the very least odd to think that an arbitrator would be entrusted with ensuring that third parties' due process rights are satisfied.").

[16] *See id.* at 16-17.

[17] *See id.* at 16.

[18] *See Concepcion*, Slip Op. at 6-9.

[19] *See id* at 7-8; *see also id.* at 8 (noting that even Respondents agreed that "[r]ules aimed at destroying arbitration or demanding procedures incompatible with arbitration . . . would be preempted by the FAA") (internal quotations omitted).

[20] *See id.* at 9-18.

[21] *See id.* at 12 n.6.

[22] *See id.* at 12-13.

[23] *See id.* at 13.

[24] Moreover, the fact that the arbitration provision at issue in *Concepcion* was particularly generous and consumer friendly likely informed the Court's decision in this case to a certain degree. *See id.* at 2 (noting the favorable arbitration agreement, including that AT&T must pay all costs for nonfrivolous claims and was prohibited from seeking attorneys' fess and that if a claimant's award exceeded AT&T's last written offer, AT&T was required to pay a minimum $7,500 recovery and twice the claimant's attorney's fees.); *id.* at 17-18 (noting that the Concepcions' claim was the least likely type of claim to go unresolved and that the Concepcions would likely fair worse as members of a class).

If you have any questions about this *Client Alert*, please contact one of the authors listed below or the Latham attorney with whom you normally consult:

Al Pfeiffer
+1.415.395.8898
al.pfeiffer@lw.com
San Francisco

Kathleen P. Lally
+1.312.777.7005
kathleen.lally@lw.com
Chicago