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Supreme Court Says Arbitration Agreements Can Derail Class Actions

April 28, 2011 by Brian Thompson

In a 5-4 decision, the U.S. Supreme Court has reaffirmed the right of businesses to compel arbitration of consumer complaints, and to block class action litigation through the enforcement of individual arbitration agreements. In so holding, the Court invalidated the prior California Supreme Court rule in *Discover Bank v. Superior Court*, 36 Cal.4th 148 (2005) that classifies most collective-arbitration waivers in consumer contracts as unconscionable. The Court held that the *Discover Bank* rule was preempted by the Federal Arbitration Act. The High Court's decision may pave the way for businesses to insist on including arbitration agreements in individual consumer service contracts as a means of derailing class action lawsuits.

The case, *AT&T Mobility LLC v. Concepcion*, 09-893, arose out of the plaintiffs' purchase of AT&T cellular phone service, which was advertised as including free phones with the signing of a service contract. While the plaintiffs were not charged for the phones, they were charged sales tax based on the phones' retail value. The plaintiffs brought a complaint against AT&T in the U.S. District Court for the Southern District of California, alleging false advertising and fraud, and the case was consolidated with a putative class action. AT&T moved to compel arbitration under the terms of its contract with the plaintiffs, which provided for arbitration of all disputes between the parties, and required that claims be brought in the parties' "individual capacity, and not as a plaintiff or class member in any purported class or representative proceeding."

The terms of the AT&T arbitration agreement actually appeared quite favorable to the consumer as described by the Court. (*See* Slip Op., p.2.) The terms required that AT&T pay all costs for non-frivolous claims; that arbitration take place in the county where the customer is billed; that arbitration of smaller claims may be conducted at the election of the consumer in person, by phone, or by submission; that either party may bring a small claims action in lieu of arbitration; that AT&T could not seek attorney's fees; and that should the consumer receive an arbitration award greater than AT&T's last written settlement offer, AT&T would be required to pay a $7,500 minimum recovery and twice the amount of the claimant's attorney's fees.

Though the District Court noted the favorability to the plaintiffs of the arbitration agreement, it nevertheless followed the rule of *Discover Bank*. The Ninth Circuit affirmed, finding the FAA did not preempt the *Discover Bank* rule. In reversing the decision of the Ninth Circuit, Justice Scalia, writing for the majority, held that the FAA preempts California's *Discover Bank* rule because that rule "stands as an obstacle to the accomplishment and execution of the full purposes and objectives of Congress."

In relevant part, the FAA, enacted in 1925, provides that "[a] written provision in . . . 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.) The FAA puts arbitration agreements "on an equal footing with other contracts." (Slip Op. p.5.) Like other contracts, agreements to arbitrate may be invalidated by generally applicable contract defenses such as fraud, duress, or unconscionability, but may not be invalidated "by defenses that apply only to arbitration or that derive their meaning from the fact that an agreement to arbitrate is at issue." (Slip Op. p.5.)

The Court held that the *Discover Bank* rule was a defense of the latter kind. The rule of *Discover Bank* was that class-action waivers in consumer contracts affecting disputes of small amounts constitute an attempt by the party with superior bargaining power to exempt itself from its own fraud, and to cheat large numbers of consumers out of individually small sums of money. They are therefore unconscionable contract terms and unenforceable. The Supreme Court held: "[w]hen state law prohibits outright the arbitration of a particular type of claim, the analysis is straightforward: The conflicting rule is displaced by the FAA." (Slip Op. p.6-7.) "[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." (Slip Op. p.7.)

"The overarching purpose of the FAA . . . is to ensure the enforcement of arbitration agreements according to their terms so as to facilitate streamlined proceedings. Requiring the availability of classwide arbitration interferes with fundamental attributes or arbitration and thus creates a scheme inconsistent with the FAA." (Slip Op. p.9.) The Court opined that class arbitration, as opposed to bilateral arbitration, "makes the process slower, more costly, and more likely to generate procedural morass than final judgment." (Slip Op. p.14.) The Court noted that, by their nature, class actions requires elements such as notice to class members and a determination of adequate class representation by the class plaintiff - procedures not suitable for disposition by an arbitrator. (Slip Op. p.15.) Additionally, the Court theorized the absence of an adequate review process makes it more likely errors will go uncorrected. (Slip Op. p.15-16.) Lastly, the Court noted that the favorable terms of the plaintiffs' arbitration agreement with AT&T make it unlikely that the plaintiffs would be left without adequate redress absent the use of class action litigation.

The Court's ruling is likely to breathe renewed life into existing arbitration agreements, especially in California, and prompt businesses that regularly enter into service contracts with consumers to include arbitration agreements requiring that claims be brought in the complainant's individual capacity, and not as a plaintiff or class member in any purported class or representative proceeding.