Does the Federal Arbitration Act Preempt California Precedent Holding That a Class Action Ban Embedded in an Arbitration Clause Is Unconscionable?

CASE AT A GLANCE

Customers brought a class action against AT&T Mobility alleging that the company's offer of a free phone to anyone who signed up for its service was fraudulent. AT&T Mobility moved to compel each customer to submit the claim to arbitration pursuant to the wireless service agreement's consumer-friendly arbitration clause. The Court must now determine whether the Federal Arbitration Act preempts state law precedent that makes unenforceable a contractual ban on class actions, even if it is embedded in an arbitration agreement that favors consumers.

AT&T Mobility LLC v. Concepcion
Docket No. 09-893

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From: The Ninth Circuit

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ISSUE

Does the Federal Arbitration Act preempt a California court decision that held that a class action ban embedded in an arbitration clause is unenforceable?

FACTS

In 2002, Vincent and Liza Concepcion, relying upon advertising by AT&T Mobility (AT&T), entered into a purchase agreement for cellular phone service at a retail outlet in California. The Concepcions purchased a Motorola phone for $149.99 and received a "free" Nokia phone, as advertised. AT&T then charged the Concepions sales tax based on the price of the Motorola phone, $18.60, plus an additional $11.72 for the "free" phone, for a total of $30.32.

The Concepions entered into a service agreement with AT&T that included an arbitration clause. The arbitration clause required the customer and AT&T to arbitrate any disputes that arise out of the agreement. The arbitration clause stated: "YOU AND AT&T AGREE THAT EACH MAY BRING CLAIMS AGAINST THE OTHER ONLY IN YOUR OR ITS INDIVIDUAL CAPACITY, AND NOT AS A PLAINTIFF OR CLASS MEMBER IN ANY PURPORTED CLASS OR REPRESENTATIVE PROCEEDING."

The Concepcions renewed their wireless service in 2003 and 2005. Each time they renewed the contract, they agreed to the current terms of service and the "change in terms clause," which authorized AT&T to "change any terms, conditions, rates, fees, expenses, or charges regarding your service at any time." In the event the terms were changed, AT&T agreed to provide its customers with notice.

On March 27, 2006, the Concepcions brought a class action suit against AT&T in the District Court for the Southern District of California for advertising the second phone for "free" and then fraudulently charging tax on the "free" phone. After the suit was initiated, AT&T revised its arbitration provision and mailed the revision to all of its customers, including the Concepcions. The revised arbitration provision included many new provisions that favored the consumer. For example, AT&T agreed that if a customer prevailed in arbitration and received more than AT&T's final offer, he or she would receive $7,500 plus double attorneys' fees. The revised terms included the following consumer-friendly provisions: the right to pursue punitive damages; venue convenient to the customer; the choice of in-person, telephone, or desk arbitration; and waiver of AT&T right to recover its attorneys' fees and the cost of arbitration. A district court observed that these provisions are "perhaps the most fair and consumer-friendly provisions this Court has ever seen." *Makarowski v. AT&T Mobility, LLC,* 2009 WL 1765661 (C.D. Cal. June 18, 2009).

The district court held that the arbitration clause was unconscionable under state law, and therefore, unenforceable. The Ninth Circuit affirmed, holding that the Federal Arbitration Act (FAA) did not preempt California law on unconscionability.

CASE ANALYSIS

At the Supreme Court, AT&T is arguing that the FAA preempts a California court decision that invalidates, as unconscionable, a class action ban contained in its arbitration clause; according to AT&T, the case should be dealt with only in arbitration. The Concepcions claim that their class action suit should be allowed to go forward. When laying out their positions, the parties deal with four distinct topics: federal policy favoring arbitration, the general trend

of nondiscrimination towards arbitration, California unconscionability laws, and the unconscionability of exculpatory provisions.

Federal Policy and Arbitration

The Federal Arbitration Act (FAA) "manifests a liberal federal policy favoring arbitration agreements." *EEOC v. Waffle House, Inc.,* 534 U.S. 279 (2002). FAA § 3 requires courts to stay litigation of claims submitted to arbitration. 9 U.S.C. § 3. Section 4 further authorizes courts to compel arbitration "in accordance with the terms of the [arbitration] agreement" so long as "the making of the agreement to arbitration" is not an issue. 9 U.S.C. § 4. Thus, the overarching purpose of the FAA is to ensure enforcement of arbitration agreements according to their terms. When interpreting an arbitration agreement, courts must give "due regard to the federal policy favoring arbitration; ambiguities as to the scope of the arbitration clause are resolved in favor of arbitration." *Mastrobuono v. Shearson Lehman Hutton, Inc.,* 514 U.S. 52 (1995).

The Concepcions and the lower courts acknowledged this general policy favoring arbitration, but then point to other parts of the FAA that they argue support California's class action ban. Section 2 of the FAA provides that arbitration agreements are "valid, irrevocable, and enforceable, as a matter of federal law … save upon such grounds as exist at law or in equity for the revocation of any contract." 9 U.S.C. § 2. Courts have construed this latter clause—the savings clause—to save from preemption all state laws that limit the enforceability of arbitration clauses as long as the law applies equally to all contracts. It was this clause that both the district court and the Ninth Circuit relied on in holding that the FAA did not preempt the state common-law definition of unconscionability.

The Ninth Circuit held that a "state law is impliedly preempted where it 'stands as an obstacle to the accomplishment and execution of the full purposes and objectives of Congress.'" According to the Ninth Circuit and the Concepcions, the California class action ban did not defeat the purposes of the FAA. The clause does not "reverse judicial hostility to arbitration agreements by placing them on the same footing as any other contract." Nor does it interfere with the efficient resolution of claims.

AT&T responds by focusing on Supreme Court precedent. The United States Supreme Court has repeatedly held that the FAA authorizes parties to create an arbitration procedure that is tailored to their needs. *Hall St. Assocs. L.L.C. v. Mattel, Inc.,* 552 U.S. 576 (2008). The Supreme Court has ruled that "parties are generally free to structure their arbitration agreements as they see fit. Just as they may limit by contract the issues which they will arbitrate, so too may they specify by contract the rules under which that arbitration will be conducted." *Volt Info. Scis., Inc. v. Board of Trustees,* 489 U.S. 468 (1989).

In reliance on this significant body of law, AT&T modified its arbitration clause to be generous to consumers while banning class actions. AT&T argues that the Supreme Court's decision in *Stolt-Nielsen S.A. v. Animal Feeds Int'l Corp.* compels the Court to uphold the class action ban. 130 S. Ct. 1758 (2010). In *Stolt-Nielsen,* the Supreme Court held that "a party may not be compelled under the FAA to submit to class arbitration unless there is a contractual basis for concluding that the party *agreed* to do so." AT&T argues that "the FAA creates a powerful presumption that parties to an arbitration agreement may select the procedures that will govern their arbitration and that courts may not refuse to enforce those agreements merely because they disagree with the procedures so selected."

Nondiscrimination Toward Arbitration

In keeping with the overall federal policy favoring arbitration, the FAA requires that state laws not discriminate against arbitration. As a general rule, as long as a state does not "single out arbitration provisions for suspect status," treat an arbitration agreement "in a manner different from that in which it otherwise construes nonarbitration provisions," or "rely on the uniqueness of an agreement to arbitrate as a basis for a state holding," the FAA's nondiscrimination standard is met.

AT&T argues that procedural rules relating to arbitration are discriminatory because they only apply to arbitration clauses rather than to all contracts. Furthermore, AT&T argues that the Ninth Circuit's decision that AT&T's arbitration agreement is unconscionable opens the door for courts to undermine arbitration by requiring procedures that are the "hallmarks of litigation, but the antithesis of arbitration." AT&T concludes that if this Court upholds the unconscionability ruling, California can "kill arbitration by converting it into litigation." The Concepcions are sensitive to AT&T's concern that states might enact procedural rules that effectively convert arbitration into litigation but respond by stating that this concern is not present here. If, however, a state were to go too far in adopting restrictive procedural rules, then the Concepcions agree that such rules would be preempted because they are incompatible with Congress's efforts to promote arbitration.

California Law Regarding Unconscionability

FAA § 2 requires courts to apply state law when determining whether an arbitration agreement as a whole is valid. Although federal law favors arbitration, § 2 allows courts to apply state contract defenses such as fraud, duress, or unconscionability when assessing the validity of an agreement. Here, the Concepcions argue that unconscionability voids the AT&T arbitration agreement.

California law provides that "a contract provision is unenforceable due to unconscionability only if it is both procedurally and substantively unconscionable." *Shoyer v. New Cingular Wireless Services,* 498 F.3d 976 (9th Cir. 2007). A contract is procedurally unconscionable if it is a product of oppression, such as a contract of adhesion; one is substantively unconscionable if it is one-sided. California adopted a "sliding scale" approach to unconscionability, which states that if the procedural unconscionability is not great, "the party attacking the term must prove a greater degree of substantive unfairness." *Marin Storage & Trucking, Inc. v. Benco Contracting & Eng'g, Inc.,* 89 Cal. App. 4th 1042 (2001).

In *Discover Bank v. Superior Court of Los Angeles,* 36 Cal. 4th 148 (2005), the California Supreme Court held that a waiver of a consumer's right to pursue class-wide arbitration was unconscionable and therefore unenforceable. The Ninth Circuit has interpreted *Discover Bank* as adopting a three-part test to determine if a class action waiver is unconscionable: (1) whether the agreement is a consumer contract of adhesion drafted by a party of superior bargaining power; (2) whether the argument occurs in a setting in which disputes between the contracting parties predictably involve small damages; and (3) whether 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." All three requirements need not be met.

Applying the *Discover Bank* test to the AT&T arbitration clause, the Ninth Circuit held that the class action ban met the *Discover Bank* three-part test for unconsionability. According to the Ninth Circuit, the first prong was met because the arbitration agreement was a contract of adhesion: The consumers did not have the ability to negotiate the terms.

The court also ruled that the class action ban met the second prong because the dispute involves predictably small damages—the amount of sales tax paid on the "free phone." The court rejected AT&T's argument that the $7,500 premium offered under the new agreement was too great to be considered "small damages." According to the Ninth Circuit, "the premium payment does not transform a $30.22 case into a predictable $7,500 case." The Ninth Circuit emphasized that the $7,500 premium was only available if AT&T offered the customer an amount less than the sum awarded by the arbitrator. The court noted that AT&T is savvy enough to "simply pay the face value of the claim" so as to avoid the premium. Thus, the court concluded, "the maximum gain to a customer for the hassle of arbitrating a $30.22 dispute is still just $30.22."

Finally, the Ninth Circuit held that the third prong was met because the Concepcions alleged that AT&T, a party with superior bargaining power, fraudulently marketed the second phone as "free" even though it knew that customers would be charged sales tax.

AT&T argues that the *Discover Bank* case deviates from established California law, which has defined unconscionability as an event that shocks the conscience, *Belton v. Comcast Cable Holdings, LLC,* 151 Cal.App. 4th 1224 (2007), "or is one that a person would have to be 'under delusion' to accept." *Herbert v. Lankershim,* 9 Cal. 2d 409 (1937). AT&T argues that clearly, a person would not be acting under delusion if he were to accept a contract term that "a reasonable person may well prefer. … By definition, a contractual term that a 'reasonable consumer may well prefer' cannot be conscience shocking."

AT&T also argues that the *Discover Bank* test is flawed because it requires a court to decide whether an agreement is unconscionable in light of the allegations made in the consumer's complaint. Here, AT&T substantially modified the clause to be much more consumer friendly after the Concepcions filed their suit. AT&T argues that despite this revision, the lower courts held that the AT&T arbitration agreement was unconscionable "even while acknowledging that any customer who invokes [AT&T's] arbitration provision is likely to obtain full relief (if not more) and that 'a reasonable person may well prefer' dispute resolution under the agreement over participating in a class action."

In response, the Concepcions contend that the agreement permits AT&T to buy off small claimants for the face amount of their claim, ensuring that the premiums it purports to offer will never actually be paid. The Concepcions cite another case involving AT&T, *Coneff v. AT&T Corp.,* 629 F. Supp. 2d 1248 (D. Wash 2009), which stated that, "the actual percentage of [AT&T] customers utilizing the allegedly 'proconsumer' provisions represents an infinitesimal amount." The court "reported that AT&T was involved in fewer than 200 consumer arbitrations—representing at that time, roughly .0029 percent of AT&T's customers—over a five-year period from 2003 to 2007." The Concepcions argue that this number is truly infinitesimal considering that AT&T has over 90 million customers. The Concepcions offer this as evidence of the "claim-suppressing effect of the ban."

The Unconscionability of Exculpatory Provisions

The Ninth Circuit held that AT&T's class action ban is further unconscionable as an unlawful exculpatory clause. California state law provides that "[a]ll contracts which have for their object, directly or indirectly, to exempt anyone from responsibility for his own fraud, or willful injury to the person or property of another, or violation of law, whether willful or negligent," are against the policy of the law. The Concepcions agree, contending that AT&T's class action ban act is an exculpatory contract because AT&T has used its superior bargaining power to carry out a scheme to defraud many consumers out of small sums. They argue that the only effective remedy is a class action.

AT&T replies that public policy rules such as those regarding exculpatory clauses are not a ground for the revocation of all contracts. AT&T argues that revocation due to public policy is specific to the type of contract involved and, therefore, does not apply uniformly to "all contracts." Furthermore, AT&T argues that because public policy is a malleable concept, if courts were to recognize public policy grounds as a reason to invalidate arbitration clauses, they would be giving states carte blanche to discriminate against arbitration, thus eliminating the intended purpose of the FAA.

SIGNIFICANCE

This case is likely to have little impact on AT&T customers who paid for the "free" phone. Undoubtedly, AT&T will rarely, if ever, get hit with the $7,500 premium payment or double attorneys' fees because it offers customers who file a complaint two or three times the charged sales tax—perhaps as much as $100—to avoid triggering the premium. It will, however, have a significant impact on cases with a higher dollar value that the company cannot easily predict.

In its amicus brief, the National Workrights Institute argues that if the Supreme Court were to rule in favor of AT&T, the impact on employment cases would be significant. The Institute argues that without the benefit of class-action litigation, employees of employers who engage in widespread discriminatory practices such as violation of wage and hour laws would not be able to afford an attorney to bring an individual lawsuit. For example, a class action against Coca-Cola, Inc. was settled for $192 million, or $81,810 for every African-American who was paid substantially less than his or her Caucasian coworkers. Research shows that the average case would have generated a 40 percent contingency fee of $32,720, but the average lawyer would have charged $120,000 to represent an individual worker. The National Workrights Institute argues that class actions allow plaintiffs to hire attorneys at prevailing rates. The Institute fears that without the assurance of adequate attorneys' fees, most attorneys would not accept such cases and many employees will be left without legal recourse.

The NAACP agrees, arguing in its amicus brief that class actions are the only way that individuals who have been historically discrimi-

nated against can obtain company-wide reform. Class actions are necessary to bring an end to pervasive discrimination in the mortgage lending, insurance, and vehicle financing industries. The NAACP argues that individual lawsuits and government enforcement of civil rights laws are inadequate substitutes for class actions.

AT&T argues that if the Court were to rule for the Concepcions, it will sound the "death knell" for arbitration in California. Because "class-arbitration is a lose-lose proposition for business, no rational business will agree to it. If told that the only way they can have an enforceable arbitration agreement is to allow for class-wide dispute resolution, businesses will give up on arbitration entirely."

AT&T hypothesizes that if the Supreme Court allows class action bans in consumer arbitration clauses, corporations will be less likely to incorporate arbitration into their agreements—a result directly at odds with the legislative intent of the Federal Arbitration Act. In fact, arbitration clauses adopted by Sprint and Verizon address this possibility by providing that in the event a court rules that the class action ban is unenforceable, the entire arbitration clause will be deemed to be invalid and the customer will have to pursue individual actions in court.

According to AT&T, invalidating class action bans will also harm consumers. First, consumers are harmed by these "blow up" clauses because even if they know they have a cause of action—which is unlikely in a case such as this—they will be unlikely to sue individually for such a small amount. Further, wireless service providers such as AT&T are able to keep costs down by requiring customers to pursue claims in arbitration. AT&T claims that if the Supreme Court holds that the class action ban is unconscionable, then corporations will incur skyrocketing litigation costs. If the Court affirms the Ninth Circuit's decision, most of the 240 million wireless customers will ultimately bear the increased costs. As the Chamber of Commerce notes in its amicus brief, "once a class is certified an action that individually might be worth only a few hundred dollars or less can instantly metastasize into a potentially catastrophic judgment of hundreds of millions or even billions of dollars of damages." Such potentially crushing damages will convince even a defendant who has engaged in no wrongdoing to settle to avoid the costs and inconvenience of litigation. The incentive to settle is increased where the class action is in arbitration because arbitration awards cannot be overturned except on extremely limited bases such as fraud.

Finally, AT&T's amici note that if the Supreme Court were to strike down AT&T's effort to offer a generous arbitration clause, then the Court will be interfering with the corporation's efforts to maintain brand loyalty. An effective consumer complaint mechanism contributes to brand loyalty and courts should not interfere by discriminating, in effect, against arbitration clauses that ban class actions. Instead, the Court should rely on the market to protect customer welfare.

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