Law of the Land: U.S. Supreme Court Upholds Arbitration Agreements Despite State Court Resistance

Arbitration is probably the oldest and best known branch in what we, in modern practice, have come to know as "ADR," alternative dispute resolution. The efficacy of arbitration has been established over the decades; specifically, its economy, swiftness, and less formalistic methodology in meting out justice stands in sharp contrast to the ever-burgeoning delays and costs inherent in litigation.

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Indeed, the budgetary constraints now imposed on the court systems in many jurisdictions, including our own, work to make arbitration the forum of choice for many disputants. In short, arbitration has been embraced by many, including the courts, as a worthy alternative to full-blown trial practice.

But this was not always the case. In its nascent years, arbitration faced unremitting hostility from the judicial system. Decades ago, state courts, in particular boldly proclaimed their opposition to arbitration, and placed significant obstacles in the way of those seeking to resolve their differences without resort to the judicial process.

It took the strong hand of the federal government in promulgating the Federal Arbitration Act (the "FAA")[1] in 1925 to once and for all establish the availability of arbitration, and the even stronger hand of the United States Supreme Court over the ensuing years to demolish parochial obstacles to arbitration, thereby opening the path to the broad acceptance of arbitration that we enjoy today.

Notwithstanding, remnants of this "litigation only" ideology occasionally crop up, and take the form of anti-ADR mechanisms that would derail otherwise valid arbitrations. One such recent example pitted a judicially created theory of the California state courts against the broad policy favoring arbitration, and became a subject of interest to the Supreme Court this term. Intervening in favor of ADR, the Supreme Court utilized its arsenal of precedents to dismantle this contrary state court theory, and thus give us this newest landmark advocating arbitration. We now discuss this timely decision.

Procedural History

AT&T Mobility LLC v. Concepcion is rooted in a rather prosaic set of circumstances.[2] The Concepcions, California residents, contracted with AT&T for wireless service. As part of the package, they received free cell phones. But, to their apparent chagrin, they still had to pay $30.22 in sales tax based upon the phones' nominal retail price. Clearly offended that their ostensibly "free" phones were not precisely free, the Concepcions commenced litigation. AT&T opposed, based upon the Concepcions' waiver of their right to litigate as class members.

The service contract between the Concepcions and AT&T contained a number of noteworthy details. First, arbitration was required, which the customer could initiate. Second, AT&T was required to pay all costs of the arbitration (unless the customer's claim was later deemed to be frivolous). Third, the arbitration had to be venued closest to the customer's home, not the company's. Fourth, for claims of $10,000 or less, the customer could choose to arbitrate in person, via telephone or on papers only.

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In addition, an "escape hatch" gave the customer the right to forego arbitration and go straight to small claims court instead. Moreover, punitive damages were allowed, AT&T was forbidden to seek attorneys' fees, and, in the event the arbitrator awarded the customer an amount that exceeded AT&T's last written settlement offer, the phone company had to pay the prevailing customer a minimum of $7,500 and twice the customer's attorneys' fees.[3]

Parenthetically, we note that, in a time when consumer arbitration agreements are often subject to harsh criticism because they sometimes favor the vendor at the expense of the ordinary citizen, the terms herein provided a fair degree of solicitude to the customer.

Yet there was one proviso of this accord that proved to be the crux of the ensuing controversy; the contract forbade arbitration of claims as a class, and delimited the customer to acting solely in its individual capacity. It was here the parties collided.

The Concepcions wished to proceed with a class action, alleging false advertising and fraud against AT&T for its surcharge of the sales taxes, while the phone company demanded the customers be compelled to follow the contract, and arbitrate their claims as individuals only.

Here is where the situs of the action preordained eventual review by the U.S. Supreme Court. Six years prior, California's highest state court had devised a new judicial doctrine, wherein it voided as unconscionable any provision of a consumer-related contract that forbade class action litigation and confined the consumer to arbitration solely on an individual basis.

That case, *Discover Bank v. Superior Court*,[4] was relied upon by the Concepcions as giving them the right to avoid individual arbitration, and instead proceed as class representatives. In opposition, AT&T argued in favor of overriding this state court construct as contrary to the strong national policy favoring arbitration. The arguments thus set in counterpoise, it was time for the Supreme Court to step in.

The Purpose of the FAA

Writing for the majority, Justice Scalia succinctly set forth the precise

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issue before the Supreme Court; does the FAA prohibit the States from denying the enforceability of agreements to arbitrate when those accords restrict or deny arbitration as a class?[5]

The linchpin of the Justices' analysis would be Section 2 of the FAA, which while wholeheartedly decreeing that agreements to arbitrate are forevermore "valid, irrevocable, and enforceable," nonetheless reserves to the courts the capability to usurp such agreements to arbitrate "upon such grounds as exist at law or in equity for the revocation of any contract."[6]

As he is wont to do, Justice Scalia commenced with a comprehensive history, here describing the rise of arbitration as a valuable mode of dispute resolution, and tracking the countervailing eradication of narrow minded judicial obstacles to the enforcement of agreements to arbitrate.

The majority noted how the FAA was enacted over 85 years ago to squelch "widespread judicial hostility to arbitration," and replace that animosity with a "liberal federal policy favoring arbitration."[7] Such notions were affirmed only a year ago by the Supreme Court in *Rent-A-Center, West, Inc. v. Jackson*,[8] where the Justices once more stated that arbitration is a matter of contract, and it is the duty of the courts to enforce such contractual arrangements that call for arbitration as the parties' chosen means of dispute resolution.

Harking back to the venerable precedent of *Volt Information Sciences, Inc. v. Board of Trustees of Leland Stanford Junior Univ.*[9], the *AT&T* majority reminds that an agreement to arbitrate, be it independent or part of a larger accord, stands on the same footing as any other contract, and thus is to be enforced according to its terms, free of judicial revisionism.[10]

To be sure, Section 2 of the FAA contains the aforementioned savings clause, a proviso by which an otherwise enforceable agreement to arbitrate can be negated on the basis of such legal or equitable principles that could be employed to revoke any contract. The force of that legislative carve-out was previously recognized by the Supreme Court, insofar as an agreement to arbitrate can be voided pursuant to the customary contract defenses, such as fraud, duress or unconscionability. Nevertheless, the statute does not invalidate an arbitration agreement for reason of a defense that applies only to arbitration or derives its meaning from the happenstance that the agreement in controversy is one to arbitrate.[11]

State Efforts to Curtail Arbitration Agreements

Having thus marshaled the linchpins of the strong federal policy favoring arbitration, Justice Scalia now turned to the state law that was obstructing its application here.

As an underlying principle, California has empowered its courts to refuse to enforce the whole or part of any contract that is found to have been unconscionable when it was made.[12] Against this statutory backdrop, the California Supreme Court (the highest court in the Golden Bear state) had decided the aforementioned *Discover Bank* case, finding invalid any waiver of the right to invoke class action procedures in an arbitration setting.

In the wake of Discover Bank, California state courts "frequently applied this rule to find arbitration agreements unconscionable."[13] On that basis, the Concepcions had persuaded the lower courts in the instant case to reject AT&T's call for them to arbitrate solely as individuals their dispute over the "free" cell phone contract.[14]

Justice Scalia immediately recognized the conflict presented by the case at bar. On the one hand, it was beyond peradventure that when a state law prohibits outright the arbitration of a particular type of claim, it is preempted as a matter of federal law and the strong federal policy favoring arbitration.

But not every situation is such a clear cut case of federal supremacy knocking to the side a state-created obstruction to arbitration. "[T]he inquiry becomes more complex," noted the Court, "when a doctrine normally thought to be generally applicable, such as duress or, as relevant here, unconscionability, is alleged to have been applied in a fashion that disfavors arbitration."[15]

The Supreme Court took a nuanced approach, warning that a lower court could not simply invoke the talisman of unconscionability and thereafter invalidate an arbitration accord, for that would allow the judiciary to effect what a state legislature could not.[16] A cogent illustration would be negating a consumer arbitration agreement because it failed to permit judicially monitored discovery, and was thus, purportedly, unconscionable.

Justice Scalia hypothesized that a state tribunal might rationalize that no ordinary citizen would knowingly give up the right to uncover a company's wrongdoing via the discovery process. Another example would be declaring as unconscionable an arbitration agreement that did not adopt the Federal Rules of Evidence.[17]

These are not fanciful musings, proclaimed the learned Justice, since the FAA itself was born out of a very real judicial hostility toward arbitration that manifested itself in a great variety of impediments disguised as rules and legal doctrines.

The majority stated its paramount concern was to "ensure the enforcement of arbitration agreements according to their terms." Invalidating an agreement to arbitrate because of a prohibition against arbitration on behalf of a class, as was the case here, "interferes with the fundamental attributes of arbitration" and is thus inconsistent with overriding federal law.[18]

Arbitrating Class Actions

The *AT&T* Court reminds that parties may fashion their agreement to arbitrate in numerous and diverse ways, such as to limit the issues subject to arbitration, to arbitrate under specific rules, to assure confidentiality, to maintain informality, and otherwise personalize the arbitral process via efficient, streamlined procedures of their own choosing.[19] Since the overarching

command of the FAA is to insure that contractual agreements to arbitrate are enforced according to their terms, courts are required to compel, rather than frustrate, arbitration when the parties agreed to that alternate forum.[20]

As such, "California's *Discover Bank* rule similarly interferes with arbitration." The ability of the consumer to negate the arbitration accord and demand class status effectively eradicates the contractually bargained-for agreement to arbitrate individually. Justice Scalia outlined the irreconcilable gulf between arbitration conducted by a solo claimant and arbitration conducted on behalf of a class.

One, class arbitration "sacrifices the principal advantage of arbitration – its informality – and makes the process slower, more costly, and more likely to generate procedural morass than final judgment."[21]

Two, class arbitration inherently and unavoidably demands procedural formalisms contradictory to the essential workings of arbitration, such as notice, accommodating absent class members, affording class members the opportunity to "opt-out," and so forth. Justice Scalia noted that at the time of the inception of the FAA in 1925, the modern-day class action was inconceivable and he frankly expressed skepticism that the lawmakers of that era wished to leave such crucial questions of due process to a mere arbitrator.[22]

Three, arbitration by a class greatly increases the risks to defendants, for reason of the lack of appellate review, the increased likelihood of error (given the inherent informality of the arbitration process), and in general the astronomical rise in the stakes for the defendant when confronted with, not one aggrieved party, but a class representative seeking "damages allegedly owed to tens of thousands of potential claimants ... aggregated and decided at once." Confronting the even small chance of suffering a devastating loss, a defendant might well feel compelled to settle a questionable class claim that it otherwise would have readily arbitrated had it been submitted on an individual basis. In sum, Justice Scalia pointedly declared that "[a]rbitration is poorly suited to the higher stakes of class litigation."[23]

Nearing its conclusion, the Supreme Court reiterated that "[a]rbitration is a matter of contract, and the FAA requires courts to honor parties' expectations."[24] In the case at bar, acquiescence to the California rule would wrongfully negate the bargain the parties had originally struck.

Put in that light, concluded the majority, the doctrine espoused by California's state courts contradicted and frustrated the strong federal policy favoring arbitration. And as must happen to all such state-created roadblocks to the supremacy of federal law, it had to be removed. Thus the forum state's doctrine was preempted, and the Concepcions were compelled to revert to arbitration of their claims on an individual, and not a class, basis.[25]

Justice Thomas' Concurrence

While the majority opinion is certainly concise enough, the concurring opinion of Justice Thomas is also worth considering.

Expressing reluctance in joining his brethren, for reason of the course charted by the majority to reach its holding, Justice Thomas preferred a different route to the same conclusion. Surely, he wrote, if the FAA means anything at all, then it means that courts cannot refuse to enforce arbitration agreements because of a state public policy against alternative means of dispute resolution, even if the state dressed such opposition in the form of a generic contract law defense.[26]

Justice Thomas proposed reading the FAA such that agreements to arbitrate are upheld unless the challenge is based upon the formation of the contract, such as the conventional defenses of fraud, duress or mutual mistake.[27] Roundly criticizing California's *Discover Bank* rule because it does not relate to defects in contract formation, Justice Thomas opined that "[c]ontract defenses unrelated to the making of the making of the agreement – such as public policy – could not be the basis for declining to enforce an arbitration clause."[28]

At the end of the day, Justice Thomas was as unequivocal as the majority in finding the rule created by judicial fiat to be wholly preempted by the FAA.[29]

Arbitration Agreements After AT&T

Having exposited the reasoning of the majority of *AT&T*, and further given due consideration to the worthwhile addition of Justice Thomas' concurring opinion, let us step back and review.

In recent decades, and, moreover, in very recent terms, the Supreme Court has provided many notable landmarks that unequivocally uphold the rightful place of arbitration in our modern legal system.[30] Each new precedent is like a great stone, increasing the size of the fortifications that defend arbitration as a worthy alternative to litigation as a mode of dispute resolution.

AT&T is another great block added to those ramparts. It cannot be doubted that the state courts of California attempted to go their own way in postulating *Discover Bank*, a holding that undercut the strong federal policy favoring arbitration. From the first, California's perspective was on a collision course with the FAA; similarly, the outcome was never seriously in doubt. As our first point of learning, we would say that this provides an object lesson to lower courts, both state and federal; do not emplace obstacles in the path of arbitration without very good cause.

Next, we note the majority's erudite reconciliation of the FAA's savings clause with the absolute need for preemption when the supremacy of federal law is challenged. Justice Scalia did not unnecessarily finesse the issue. He cogently exposited how the reservation of the States' rights to maintain nominal contract defenses, even in the face of much favored arbitration agreements, were not compromised by this holding.

In sharp contradistinction to the contention that Section 2 of the FAA would resurrect the *Discover Bank* rule, the majority patiently demonstrates that California's judicial construct was not a proper exercise of its traditional power of allocating defenses in state law contract disputes. Justice Scalia made a comprehensive exhibition of how this provincial rule was a not-so-subtle attack upon the arbitration process itself, and,

in turn, the supremacy of the FAA. Put another way, the rule created by California's highest court ranged far afield from mere contract law; it was a blatant obstruction to a decades-old national policy favoring arbitration. Preemption was therefore the only just outcome.

Furthermore, Justice Thomas' concurring opinion is not insignificant. Indeed, we find it to be meritorious in its own fashion, for two main reasons. First, it runs true to the majority in its staunch defense of federal preemption, and thus validating ADR. Second, it presents its own cogent methodology by cabining the application of the FAA's saving clause to defenses truly grounded in contract formation. In this way, it commits no offense against the States' rights to apply their own longstanding principles of contract law, yet nonetheless is an effective preventive against interference in a realm where federal law reigns supreme.

In conclusion, we return to our opening observations. Arbitration has long been recognized as a vital component of our system of justice, providing an alternative to costly and time consuming litigation. Its rightful role has been assured via decades of Supreme Court precedents. *AT&T* is the most recent addition to that solid wall of decisions favoring arbitration.[31] Today, as our court systems, federal, state, and local, suffer from overcrowding, delays, and budgetary restraints, *AT&T* shall play a vital role in assuring that justice, via the alternative means of arbitration, will still be done.

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1. 9 U.S.C. § 1, et seq.
2. 563 U.S. ___ (April 27, 2011). The slip opinion is available at <www.supremecourt.gov> among the 2010 Term opinions of the Court.
3. *AT&T*, slip op. at 2.
4. 36 Cal. 4th 148 (2005).
5. *AT&T*, slip op. at 1.
6. *Id.*
7. *Id.* at 4. quoting *Moses H. Cone Memorial Hospital v. Mercury Constr. Corp.*, 460 U.S. 1, 24 (1983).
8. 130 S.Ct. 2772 (2010).
9. 489 U.S. 468, 478 (1989).
10. *AT&T*, slip op. at 5. *See also* A.M. Sabino, "Awarding Punitive Damages In Securities Industry Arbitration: Working For A Just Result," 27 U. of Richmond L. Rev. 33, 34-39 (1992) (summarizing leading Supreme Court cases announcing strong federal policy favoring arbitration).
11. *Id.*
12. *Id.* (citing Cal. Civ. Code Ann. § 1670.5(a) (West 1985)).
13. *Id.* at 6.
14. *Id.* at 3–4. *See also id.* at 17–18 (reversing sub nom. 584 F.3d 849 (2009)).
15. *Id.* at 7.
16. *Id.*
17. *Id.* at 8.
18. *Id.* at 9.
19. *Id.* at 10.
20. *Id.* at 11.
21. *Id.* at 14.
22. *Id.* at 15.
23. *Id.* at 16.
24. *Id.* at 17.
25. *Id.*
26. *AT&T*, slip op. at 1. (Thomas, J., concurring).
27. *Id.* at 3–4. (Thomas, J., concurring).
28. *Id.* at 4. (Thomas, J., concurring). *See also Morgan Stanley Capital Group v. Public Util. Dist. No. 1 of Snohomish City*, 554 U.S. 527, 547 (2008) (describing fraud and duress as traditional grounds for abrogating a contract because of defects in the contract's formation).
29. *Id.* at 6. (Thomas, J., concurring).
30. *See, e.g., Rent-A-Center, West v. Jackson*, 130 S.Ct. 2772 (2010); *Stolt-Nielsen S.A. v. AnimalFeeds Int'l Corp.*, 130 S.Ct. 1758 (2010).
31. As this article went to press the Supreme Court issued a per curiam opinion in *KPMG LLP v. Cocchi*, No. 10–1521 (Nov. 7, 2011), available at <www.supremecourt.gov> among the 2011 Term opinions. The Court reaffirmed that "the emphatic federal policy in favor of arbitral dispute resolution" demands that state and federal courts "enforce the bargain of the parties to arbitrate."