Sword of US Class Arbitration Beaten to Ploughshares

by

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In the long-awaited decision in *AT&T Mobility LLC v Concepcion*,[1] the US Supreme Court struck down state laws that invalidate class arbitration waiver provisions in consumer agreements. The majority's decision opens the door for US companies to contract around consumer class actions by including terms in consumer contracts that mandate bilateral arbitration between the company and the consumer.

1. The High-Stakes Dispute over the Enforceability of Class Arbitration Waivers in the United States

In the United States, an individual can initiate a class action lawsuit on behalf of other similarly situated consumers. If certified to proceed on a classwide basis, the action includes any person within the definition of the class. The attorneys who represent the class typically work at risk. If the class obtains a financial recovery through adjudication or settlement, the attorneys for the class generally receive a fee award of around 25 per cent of the financial recovery. The aggregation of consumer disputes involving relatively nominal sums can generate millions of dollars in fee awards.

Faced with a steady stream of consumer class actions, US companies began inserting "class action waivers" in consumer contracts. Under these waiver provisions, the consumer agreed in advance to waive the right to adjudicate claims on a classwide basis. But the laws of some states invalidated these waivers as a matter of public policy. Under California law, for example, such waivers are unconscionable in adhesion contracts because the waiver results in an "exemption of the party" from responsibility for its own misconduct.[2]

In *Concepcion*, the Supreme Court held that the Federal Arbitration Act (FAA) §2[3] pre-empted the California state law, as it applied to arbitration agreements, because the Court believed that such a state law conditioned the "enforceability of certain arbitration agreements on the availability of classwide arbitration procedures".[4] Stated another way, the majority decision upheld the validity of consumer class arbitration waivers. The decision only applies to arbitration agreements; it neither addresses nor saves consumer class action waivers in judicial proceedings. However, US companies that require consumers to waive the right to class arbitration must offer the consumers some unusual procedural safeguards. The Supreme Court's process in arriving at this far-reaching result warrants discussion, beginning with the underlying facts.

2. Another Tax Skirmish Reshapes the United States, but this Time it is Mobile Phones in California, not Tea in Boston Harbour

US wireless companies frequently offer free or discounted mobile phones to consumers who agree to enter a long-term contract (typically two years) for wireless service. At the time of purchase, most states impose a sales tax on the mobile phone, but not on the contract for wireless service. To avoid the loss of sales tax on these so-called "bundled" transactions involving a mobile phone and wireless service, California imposes sales tax on the imputed

[1] *AT&T Mobility LLC v Concepcion*, 563 U.S. ___, 131 S. Ct. 1740 (2011).
[2] *Concepcion*, 563 U.S. ___, 131 S. Ct. 1740 (2011) at 1746 (citation and quotation omitted).
[3] 9 U.S.C. §2.
[4] *AT&T Mobility v Concepcion*, 563 U.S. ___, 131 S. Ct. 1740 (2011) at 1744.

retail value of mobile phones, including free mobile phones. As with all sales tax, the retailer calculates the applicable amount, which varies depending on the store's precise location, and provides the consumer with a receipt at the time of purchase.

The Concepcions entered into a bundled contract with AT&T[5] for wireless service, under which they received free mobile phones and paid US $30.22 in sales tax based on the retail value of the mobile phones. In March 2006, the Concepcions filed a putative class action lawsuit in the federal court in the Southern District of California, alleging that AT&T cheated them by charging them sales tax on mobile phones that AT&T had advertised as free.

The Concepcions' agreement with AT&T contained a provision that required adjudication of all claims on an individual basis, either through bilateral arbitration between the company and the consumer or in a small claims court. Under the arbitration provision, AT&T agreed to pay all costs for non-frivolous claims and to conduct the arbitration in the location where the customer is billed. Further, if the customer received an arbitration award greater than AT&T's last settlement offer, the provision required AT&T to pay the consumer a US $7,500 bounty (subsequently increased to US $10,000), plus double the attorneys' fees. The clause did not allow for class arbitration or judicial class actions, and it contained a self-destruct provision, which would invalidate the entire arbitration provision if a court refused to uphold the class arbitration waiver.

AT&T filed a motion with the trial court under the FAA §4 to compel arbitration of the Concepcions' claims. The trial court acknowledged that the AT&T arbitration provision was "quick, easy to use" and likely to result in a full or "even excess payment to the customer without the need to arbitrate or litigate". It also noted that the US $7,500 premium functioned as a "substantial inducement" for the consumer to pursue the claim in arbitration. Nonetheless, applying California state law, the trial court determined that the arbitration provision was unconscionable and unlawfully exculpatory because: (i) like virtually all consumer contracts, it involved a contract of adhesion; (ii) the claim involved a small amount of damages; and (iii) AT&T allegedly carried out a scheme to cheat large numbers of consumers out of small sums of money by charging them sales tax on mobile handsets advertised as free.[6] The Ninth Circuit Court of Appeals affirmed the trial court decision, and AT&T appealed to the US Supreme Court. In a 4-1-4 decision (plurality—concurrence—dissent), a slim majority of the US Supreme Court reversed on the ground that the FAA §2 pre-empted California state law.

3. Arbitration, as American as Apple Pie

In response to "widespread judicial hostility", Congress passed the FAA in 1925 to place arbitration agreements on an equal "footing" with other contracts.[7] In the US version of events, English courts, apparently overcome with jealousy of arbitrators, refused to enforce agreements to arbitrate:

> "American courts initially followed English practice, perhaps just standing upon the antiquity of the rule prohibiting arbitration clause enforcement, rather than upon its excellence or reason."[8]

Section 2, the primary substantive provision of the FAA, provides that written agreements to arbitrate "shall be valid, irrevocable, and enforceable, save upon such grounds as exist at law or in equity for the revocation of any contract". In other words, under the savings

[5] The Conceptions' original contract was with Cingular Wireless which, as the result of a series of acquisitions and name changes, operates as AT&T Mobility.

[6] See *AT&T Mobility v Concepcion*, 563 U.S. ___, 131 S. Ct. 1740 (2011) at 1746 (quoting *Discover Bank v Superior Court*, 36 Cal. 4th 148, 162; 113 P.3d 1100, 1110 (2005)).

[7] *Concepcion*, 563 U.S. ___, 131 S. Ct. 1740 (2011) at 1745.

[8] *Allied-Bruce Terminix Cos v Dobson*, 513 U.S. 265, 270 (1995) (citation and quotation omitted).

clause, states may regulate arbitration clauses under general contract law principles such as fraud, duress or unconscionability. But the FAA §2 pre-empts state laws that apply only to arbitration or arbitration agreements.

By way of example, in an earlier decision, the US Supreme Court held that the FAA pre-empted a Montana state law that required contracts containing arbitration provisions to include a notice on the first page, underlined and in capital letters, pointing out the arbitration clause.[9] The Supreme Court invalidated the state law because, by its terms, the notice provision applied exclusively to agreements to arbitrate.[10] When state law involves such "outright" restrictions on arbitration, the "analysis is straightforward".[11]

4. When Do Seemingly Neutral State Laws Interfere with Arbitration?

The Concepcions' lawsuit posed the more difficult question of whether the Court should pre-empt an ostensibly neutral law because the law could, in practical effect, contravene the purposes of arbitration and the FAA. Here, California law prohibiting consumer class action waivers applies equally to class arbitration waivers and judicial class action waivers.[12] To the dissent, this equal treatment of class action waivers disposed of the question:

> "we should think more than twice before invalidating a state law that does just what §2 requires, namely, puts agreements to arbitrate and agreements to litigate 'upon the same footing'."[13]

The dissent also pointedly criticised the majority for using federal law to strike down state law: "We do not honor federalist principles in their breach".[14]

The majority remained unconvinced. As the majority pointed out, hostility towards arbitration manifests itself in "a great variety of devices and formulas".[15] To illustrate its point, the majority described a hypothetical state law that, as a matter of public policy, required judicially monitored discovery to prevent companies from hiding their wrongdoings.[16] While in theory the law would apply with equal effect to any contract, in practice the rule would have a "disproportionate impact on arbitration agreements".[17] The majority suggested that such examples of thinly disguised attacks on arbitration through seemingly neutral laws were "easy to imagine".[18] The majority went on to contemplate additional examples, including state laws imposing the Federal Rules of Evidence or trial by jury.[19] The Concepcions disparaged these examples as a "parade of horribles".[20] But this abstract discussion set the stage for the majority's key assertion that the FAA required pre-emption of California's law because "[r]equiring the availability of classwide arbitration", the effective result of invalidating the class arbitration waiver, "interferes with fundamental attributes of arbitration".[21]

[9] *Doctor's Assocs., Inc. v Casarotto*, 517 U.S. 681, 683 (1996).
[10] *Doctor's Assocs., Inc. v Casarotto*, 517 U.S. 681, 687 (1996).
[11] *AT&T Mobility v Concepcion*, 563 U.S. ___, 131 S. Ct. 1740 (2011) at 1747.
[12] See *Concepcion*, 563 U.S. ___, 131 S. Ct. 1740 (2011) at 1746–1747.
[13] *Concepcion*, 563 U.S. ___, 131 S. Ct. 1740 (2011) at 1758 (Breyer J., dissenting).
[14] *Concepcion*, 563 U.S. ___, 131 S. Ct. 1740 (2011) at 1762.
[15] *Concepcion*, 563 U.S. ___, 131 S. Ct. 1740 (2011) at 1747 (citation and quotation omitted).
[16] *Concepcion*, 563 U.S. ___, 131 S. Ct. 1740 (2011) at 1747.
[17] *Concepcion*, 563 U.S. ___, 131 S. Ct. 1740 (2011) at 1747.
[18] *Concepcion*, 563 U.S. ___, 131 S. Ct. 1740 (2011) at 1747.
[19] *Concepcion*, 563 U.S. ___, 131 S. Ct. 1740 (2011) at 1747.
[20] *Concepcion*, 563 U.S. ___, 131 S. Ct. 1740 (2011) at 1747.
[21] *Concepcion*, 563 U.S. ___, 131 S. Ct. 1740 (2011) at 1748.

5. Invalidating Class Arbitration Waivers Effectively Rewrites the Parties' Arbitration Agreement

In the end, the majority concluded that class arbitration conflicted with "the fundamental principle that arbitration is a matter of contract", and arbitration provisions, on an "equal footing with other contracts", must be enforced "according to their terms".[22] In particular, California law allowed a consumer to demand arbitration ex post.[23] To the extent that class arbitration was manufactured by California law, rather than being consensual, the state law was inconsistent with the FAA. The majority offered three reasons why the switch from bilateral arbitration between the company and the consumer to class arbitration changes the nature of the parties' agreement. First, class arbitration undermines the basic premise of arbitration—an expedited, inexpensive process to resolve consumer disputes.[24] Secondly, arbitration procedures lack the formality necessary to protect absent class members.[25] Thirdly, corporations agree to arbitrate small consumer disputes because the impact of an incorrect decision is nominal. In contrast, class arbitration puts companies at considerable risk by aggregating consumer claims without providing the defendant with a corresponding and full right to appeal.[26]

6. Justice Thomas's Reluctant Concurrence: a Cramped Argument for Federal Pre-emption

In his concurrence, Thomas J. took the view that there is no such thing as implied pre-emption (or "purposes-and-objectives" pre-emption, as he called it),[27] but only express pre-emption. He therefore set out to determine whether the FAA expressly pre-empted the California law at issue. The FAA §2 requires arbitration of disputes "save upon such grounds as exist at law or in equity for the *revocation* of any contract" (emphasis added). According to Thomas J., the term "revocation" in the Act permits only defences to the making of the agreement, such as fraud, duress and mutual mistake. He further concluded that the California state law at issue did "not concern whether the contract was properly made" because it judicially invalidated class arbitration waivers as a matter of public policy.[28] However, because his statutory analysis similarly concluded that the FAA pre-empted the California law at issue, in a deliberate effort to create a majority opinion, Thomas J. "reluctantly" joined the plurality opinion.[29]

7. Equal Footing for Class Arbitration Depends on Whose Shoes You Stand In

The majority analyses class arbitration largely from the defendant corporation's perspective, while the dissent and the Concepcions, in broad outline, focus on the plaintiff consumer's point of view. The majority all but acknowledges this difference in perspective when it states, "[w]e differ with the Concepcions only in the application of [our] analysis to the matter before us".[30]

For the dissent, allowing class arbitration puts arbitration agreements on an equal footing with all other contracts because it allows adjudication on a classwide basis of both arbitrated and judicial disputes related to the contract. The dissent also criticised the majority for

[22] *Concepcion*, 563 U.S. ___, 131 S. Ct. 1740 (2011) at 1745 (citations omitted); see also at 1752.
[23] *Concepcion*, 563 U.S. ___, 131 S. Ct. 1740 (2011) at 1750.
[24] *Concepcion*, 563 U.S. ___, 131 S. Ct. 1740 (2011) at 1751.
[25] *Concepcion*, 563 U.S. ___, 131 S. Ct. 1740 (2011) at 1751.
[26] *Concepcion*, 563 U.S. ___, 131 S. Ct. 1740 (2011) at 1752.
[27] *Concepcion*, 563 U.S. ___, 131 S. Ct. 1740 (2011) at 1754 (Thomas J., concurring).
[28] *Concepcion*, 563 U.S. ___, 131 S. Ct. 1740 (2011) at 1756 (Thomas J., concurring).
[29] *Concepcion*, 563 U.S. ___, 131 S. Ct. 1740 (2011) at 1754.
[30] *Concepcion*, 563 U.S. ___, 131 S. Ct. 1740 (2011) at 1748.

focusing on the potential disadvantages of class arbitration without considering any of its countervailing advantages. The dissent contends that class arbitration advances the purpose of arbitration by providing an efficient dispute resolution mechanism for disputes involving a large number of consumers. Indeed, the dissent believes that class actions provide virtually the only such mechanism:

> "What rational lawyer would have signed on to represent the Concepcions in litigation for the possibility of fees stemming from a $30.22 claim? The realistic alternative to a class action is not 17 million individual suits, but zero individual suits as only a lunatic or a fanatic sues for $30."[31]

For the majority, however, introducing class arbitration midstream, after the company and the consumer agreed to waive class claims, fundamentally rewrites the parties' arbitration agreement. In particular, judicial imposition of class arbitration exposes corporate defendants to an entirely different set of risks. A company that had originally agreed to trade away the right to a full appeal in exchange for an inexpensive and efficient resolution of relatively nominal disputes involving a single consumer would suddenly find itself subject to massive claims by a class of consumers without the full-blown procedural safeguards of a judicial proceeding. The small chance of a devastating loss effectively requires corporations either to forgo arbitration, as would have occurred in this case if the Supreme Court had failed to uphold the validity of the class action waiver, or to enter into *in terrorem* settlements.

From these competing points of view, bilateral arbitration emerges ascendant. The Court's decision is likely to reduce the number of judicial class actions in the United States in favour of bilateral arbitration of consumer disputes between just the company and the consumer.

[31] *Concepcion*, 563 U.S. ___, 131 S. Ct. 1740 (2011) at 1761 (Breyer J., dissenting) (citations, emphasis and quotation omitted).