



To read the transcript of the oral argument in *AT&T Mobility LLC v. Concepcion*, please [click here](#).

The Supreme Court Considers Whether the FAA Preempts State Court Decision Holding Class Arbitration Waiver Unenforceable

November 11, 2010

INTRODUCTION

On Tuesday, in *AT&T Mobility LLC v. Concepcion*, No. 09-893, the United States Supreme Court heard argument on whether the Federal Arbitration Act (“FAA”) preempts a state court decision striking down an arbitration agreement that precludes class arbitration. Specifically, the California Supreme Court held that an arbitration agreement that precludes class relief is unconscionable and therefore unenforceable in contracts of adhesion where the disputes between the parties are likely to involve small amounts and the plaintiff alleges that the party with superior bargaining power has defrauded large numbers of customers out of individually small sums of money. This case offers the Court an opportunity to determine the enforceability of arbitration agreements that preclude class action arbitration, and more generally to provide guidance on the proper roles of federal and state law in shaping arbitration.

BACKGROUND

Plaintiffs Vincent and Lisa Concepcion signed a two-year wireless service agreement with AT&T for cellular phone services in February 2002. AT&T offered a “free” cell phone in return for the Concepcions’ acceptance of the two-year service contract.

On March 27, 2006, the Concepcions filed a complaint in the United States District Court for the Southern District of California alleging that AT&T engaged in fraud by offering a “free” phone when, in fact, AT&T charged Plaintiffs sales tax on the retail value of the phone. The amount at issue was approximately \$30.22. In September 2006, the district court consolidated the Concepcions’ case with a putative class action involving the same issues.

Each plaintiff in the class entered into separate but identical wireless service agreements with AT&T. Each agreement included both: (1) an arbitration clause, requiring any disputes to be submitted to arbitration; and (2) a class action waiver, requiring any dispute between the parties to be brought in an individual capacity and not on behalf of a class. In December 2006, AT&T revised the agreements to add a “new premium payment clause” designed to incentivize customers to pursue small-value claims. This new clause provided that, if an arbitrator issued an award in favor of a customer that was greater than AT&T’s last written settlement offer made before the arbitrator was selected, then AT&T would pay the customer \$7,500.

The Report From Washington is published by the Washington, DC office of Simpson Thacher & Bartlett LLP.

AT&T filed a motion to compel Plaintiffs to submit their claims to individual, bilateral arbitration based on the arbitration clause, the class action waiver, and the new premium payment clause. To avoid bilateral arbitration, Plaintiffs argued that the class action waiver was unconscionable under California law. In support, Plaintiffs relied on *Discover Bank v. Sup. Ct.*, 113 P.3d 1100 (Cal. 2005), in which the California Supreme Court held that waivers of class relief are unconscionable if: (1) the agreement is a contract of adhesion; (2) the disputes between the contracting parties are likely to involve small amounts of damages; and (3) it is alleged that the party with superior bargaining power carried out a scheme to deliberately cheat large numbers of customers out of individually small sums.

AT&T maintained that the *Discover Bank* rule was inapplicable because of the new premium payment clause added in December 2006. AT&T principally argued that the prospect of \$7,500 should provide customers with adequate incentive to pursue small-value claims in bilateral arbitration, and the clause would function to punish AT&T should it make low-ball offers to settle. These two effects removed any possibility that AT&T enjoys effective immunity from small claims affecting large numbers of customers.

The district court found that "a reasonable person may well prefer" the process established by AT&T over class action litigation: customers were "virtually guaranteed" payment of small claims and there was "substantial inducement" to pursue those claims. But notwithstanding individual customer preferences, the court explained, California law requires class relief to deter wrongdoing *generally*. "Faithful adherence to California's stated policy of favoring class litigation and arbitration to deter alleged fraudulent conduct in cases involving large numbers of consumers with small amounts of damages compels the Court to invalidate AT&T's class waiver provision."

On appeal, the United States Court of Appeals for the Ninth Circuit affirmed the district court's interpretation of California law, but for a different reason. According to the Ninth Circuit, customers did *not* have any incentive to pursue small claims despite the new premium payment clause. Once a customer filed for arbitration, the court reasoned, AT&T would simply offer to pay the face value of the claim before the selection of an arbitrator. "Thus, the maximum gain to a consumer for the hassle of arbitrating a \$30.22 dispute is still just \$30.22." Therefore, under the *Discover Bank* rationale, the waiver was unconscionable.

The Ninth Circuit also noted that unconscionability is a well-established and generally applicable contract defense existing under state law. It rejected AT&T's argument that *Discover Bank* is a "new rule" special to arbitration clauses and not justified by the traditional principles of unconscionability: "[T]he rule announced in *Discover Bank* is simply a refinement of the unconscionability analysis applicable to contracts generally in California." Moreover, the court continued, the purpose of the FAA is to place arbitration agreements on the same footing as any other contract, and the *Discover Bank* rule is consistent with that purpose.

The Supreme Court granted AT&T's petition for writ of certiorari on May 24, 2010.

SUMMARY OF THE ARGUMENT

At oral argument, AT&T took issue with the Ninth Circuit's conclusion that so long as state law requires the use of a particular procedure in litigation, it is consistent with the FAA to require that procedure in arbitration. This interpretation, AT&T argued, would permit a state to make arbitration "a carbon copy of litigation," contrary to the purposes of the FAA. Rather, the critical question that should decide the case is whether the state is applying the same principles of unconscionability to arbitration agreements as it applies to other agreements. The *Discover Bank* rule, according to AT&T, failed this test.

Justice Sotomayor asked what role the Supreme Court had in determining unconscionability under California law: "We have to serve as reviewers of state law? We have to look at what states are doing ... to interpret their own laws?" AT&T argued that the Court could and should do so if the state court holding was discriminatory against arbitration. Though AT&T conceded that a state could change the general principles it applies to any contract if it wanted to, states must apply those changes even-handedly. "The problem here [is] it has the label 'unconscionability' on it," AT&T claimed, "but the test that is applied has nothing to do with the test that is applied in every other context."

Justice Ginsburg observed: "There is nothing that indicates that California's laws are applying a different concept of unconscionability." She added: "You are not claiming that, vis-à-vis litigation, arbitration is being disfavored, which was the original concern about arbitration agreements and what prompted the [FAA]." Justice Kagan, too, noted that the *Discover Bank* rule applies equally to contracts that do not contain arbitration clauses. AT&T maintained, however, that the rule has a much more significant, transformative effect on arbitration than it has on litigation, and that the analysis in *Discover Bank* was unlike traditional unconscionability analysis.

Several justices pressed AT&T as to where to draw the line: what procedures can be held unconscionable by states and what procedures cannot be because they were discriminative of arbitration? Justice Sotomayor, however, doubted that the emphasis on procedures was correct: "They are identifying a class of cases in which ... there is a substantive right being affected. That is different than rules that are looking at procedures and setting uniform procedures in both."

Plaintiffs set forth three principle points for why the *Discover Bank* rule was consistent with the FAA: (1) "it is consistent with the equal footing principle or nondiscrimination principle that this Court has consistently recognized is embodied in Section 2"; (2) "arbitration under the FAA ... represents a choice of forum, but it doesn't withdraw the parties from the substantive liability rules of the state"; and (3) the law at issue is a legitimate application of the state's common law to which the Supreme Court should defer.

Plaintiffs disputed AT&T's claims that the California Supreme Court applied a new rule, maintaining that *Discover Bank* can be read to have determined the fairness of the arbitration agreement to the party before the court, at the time of contracting, and under the proper unconscionability standard applied in all other contexts.

"We have to serve as reviewers of state law? We have to look at what states are doing ... to interpret their own laws?"

JUSTICE SOTOMAYOR

"There is nothing that indicates that California's laws are applying a different concept of unconscionability"

JUSTICE GINSBURG

"The question is not whether they are being forced to accept class arbitration; it's whether they are being coerced into abandoning regular arbitration."

JUSTICE SCALIA

Justice Alito commented: "If the district court understood ... correctly [that] the scheme here is found to be unconscionable because it doesn't allow the enlistment of basically private attorneys general to enforce the law ... isn't that quite different from ordinary unconscionability analysis?" Chief Justice Roberts, too, noted that "[i]t's a different mode of analysis than I'm familiar with under basic contract law." Plaintiffs disagreed, citing California cases where shortened statutes of limitations were held unconscionable because they interfered with parties' ability to take action on a claim.

Justice Sotomayor, as she had done with AT&T, pressed for a rule to guide the Court: "How would you propose to distinguish between facially neutral contract law defenses that implicitly discriminate against arbitration and those that do not?" Plaintiffs conceded that states may try to disfavor arbitration under the guise of facially neutral contract law defenses and that that would be impermissible. To tell if that was the case, Plaintiffs explained: "You would see whether the state court is telling the truth. Is this law really being applied in the same way in the arbitration context and outside the arbitration context?" California, Plaintiffs maintained, was telling the truth that its rule applied equally because the *Discover Bank* case relied on a non-arbitration case and applied that rule in precisely the same way.

Justice Ginsburg questioned Plaintiffs as to the impact of the Court's recent decision in *Stolt-Nielsen*: "In *Stolt-Nielsen* this Court said that, absent express consent, no class arbitration. ... AT&T has not consented to class arbitration. ... So why isn't *Stolt-Nielsen* dispositive of this case?" Plaintiffs distinguished the case on the grounds that the question here is whether the arbitration agreement is valid in the first place, rather than a question of contract interpretation. Plaintiffs added: "Nobody is forcing defendants to face class arbitration, and nobody is forcing them to face it on terms that they haven't consented to." Justice Scalia, however, reframed the question: "The question is not whether [AT&T is] being forced to accept class arbitration; it's whether [it is] being coerced into abandoning regular arbitration."

On rebuttal, AT&T took issue with Plaintiffs' suggestion that class arbitration is an acceptable procedure. "We are not aware ... of any contract that explicitly permits class arbitrations for the reasons that the Court discussed [in *Stolt-Nielsen*]. It's just not something that makes any sense."

IMPLICATIONS

Concepcion represents the natural next step for the Court in the wake of its recent decisions, *Green Tree Financial Corp v. Bazzle*, 539 U.S. 444 (2003), and *Stolt-Nielsen SA v. AnimalFeeds Int'l Corp.*, 130 S. Ct. 1758 (2010). In *Bazzle*, the Court found that class arbitration is permissible if parties agree to class arbitration. *Stolt-Nielsen* then held that class arbitration is impermissible unless parties affirmatively authorize class arbitration. Silence on the issue is insufficient. Now, in *Concepcion*, the Court will address the final piece to the puzzle, namely, whether an agreement to preclude class arbitration is valid, and the proper balance between federal and state law in making that determination.

For further information about this decision, please feel free to contact members of the Firm's Litigation Department, including:

New York City:

Andy Amer
212-455-2953
aamer@stblaw.com

Mary Beth Forshaw
212-455-7039
mforshaw@stblaw.com

Joe McLaughlin
212-455-3242
jmclaughlin@stblaw.com

Barry Ostrager
212-455-2655
bostrager@stblaw.com

Robert Smit
212-455-7325
rsmit@stblaw.com

Mary Kay Vyskocil
212-455-3093
mvyskocil@stblaw.com

Washington DC:

Peter Thomas
202-636-5535
pthomas@stblaw.com

London:

Tyler Robinson
011-44-20-7275-6118
trobinson@stblaw.com

The contents of this publication are for informational purposes only. Neither this publication nor the lawyers who authored it are rendering legal or other professional advice or opinions on specific facts or matters, nor does the distribution of this publication to any person constitute the establishment of an attorney-client relationship. Simpson Thacher & Bartlett LLP assumes no liability in connection with the use of this publication.

UNITED STATES

New York

425 Lexington Avenue
New York, NY 10017
+1-212-455-2000

Los Angeles

1999 Avenue of the Stars
Los Angeles, CA 90067
+1-310-407-7500

Palo Alto

2550 Hanover Street
Palo Alto, CA 94304
+1-650-251-5000

Washington, D.C.

1155 F Street, N.W.
Washington, D.C. 20004
+1-202-636-5500

EUROPE

London

CityPoint
One Ropemaker Street
London EC2Y 9HU
England
+44-(0)20-7275-6500

ASIA

Beijing

3119 China World Office 1
1 Jianguomenwai Avenue
Beijing 100004
China
+86-10-5965-2999

Hong Kong

ICBC Tower
3 Garden Road, Central
Hong Kong
+852-2514-7600

Tokyo

Ark Mori Building
12-32, Akasaka 1-Chome
Minato-Ku, Tokyo 107-6037
Japan
+81-3-5562-6200

SOUTH AMERICA

São Paulo

Av. Presidente Juscelino Kubitschek, 1455
São Paulo, SP 04543-011
Brazil
+55-11-3546-1000