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Enforcing arbitration agreements: Unconscionability is still the battleground, but for how long?

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Dealers are under assault by consumers and employees who, in a still-recovering economy, too often seek windfalls through the court system to address their own economic troubles. The proliferation of class action lawsuits has some smaller dealers wondering whether continuing in business is worth all the effort. Even larger dealer groups stand to lose a great deal in the event a court determines that rescission is an available class-wide remedy for the wrongdoing alleged. Since the courts in many states look to California's decisions as they consider pre-dispute arbitration provisions, it is worthwhile to review the state of the law in this area in California.

The California New Car Dealers Association has been effective at getting some legislation passed to curb abusive litigation. Most notable is AB 238 in 2011 which amended the Automobile Sales Finance Act, Cal. Civ. Code § 2981-2984.6, so that the mere failure to properly disclose government fees on a retail installment sale contract will not make the sale contract unenforceable (and subject to rescission). 2011 Cal. AB 238, 2011 Cal. Stats. ch. 526. But in states that have no such limitation, arguably making rescission a remedy, class action cases stand to wreak havoc on dealerships. The economic value of these cases to plaintiff-class counsel comes from the large attorney-fee awards they stand to generate. To obtain court approval for large attorney's fees awards, class counsel must show that a substantial value was bestowed on the class. In the absence of a rescission remedy, very little of value can be bestowed on the class in many disclosure-based class actions (*e.g.*, DMV fee lumping, improper tire fee disclosure, or back-dating cases), resulting in what many plaintiffs' lawyers consider insufficient awards of prevailing-party attorney's fees.

So the question is: What is the most efficient defense against these cases? A dealer should consider a valid and enforceable pre-dispute arbitration clause, containing a class-action waiver, in every vehicle sale contract. If enforced in response to a consumer class action, the plaintiff's class action lawsuit is reduced to a single plaintiff claim that the plaintiff must arbitrate before a private arbitrator, significantly reducing liability exposure for the dealership.

The plaintiffs' bar has vigorously argued in state and federal courts that arbitration-clause class-action waivers are (or should be) unenforceable. And until 2011, they were successful, at least in California, in limiting the enforcement of class action waivers under the California supreme court's holdings in *Discover Bank v. Superior Court*, 36 Cal. 4th 148 (2005) and *Gentry v. Superior Court*, 42 Cal. 4th 443 (2007). In *Discover Bank,* the court held that where a case involves a defendant's practice of bilking a large number of consumers out of small individual sums of money, the class action waiver will not be enforceable. 36 Cal. 4th at 162. In *Gentry,* the court held that in the

employment context, a class action waiver will not be enforced for public policy reasons, if certain factors exist. *See* 42 Cal. 4th 443.

But 2011's landmark United States Supreme Court decision in *AT&T Mobility v. Concepcion*, 131 S. Ct. 1740 (2011), invalidated the California Supreme Court decision of *Discover Bank*, 36 Cal. 4th 148 (2005). In rejecting the *Discover Bank* rule, the United States Supreme Court held that state law and public policy can no longer be applied in a manner that disfavors arbitration because state law or public policy is preempted by the Federal Arbitration Act (9 U.S.C. §2). 131 S. Ct. at 1753.

Some commentators suggested that *Concepcion* did not apply to California's other anti-arbitration decisions, such as *Broughton v. Cigna Healthplans*, 21 Cal. 4th 1066, 1082-84 (1999) and *Cruz v. Pacificare Health Systems, Inc.*, 30 Cal. 4th 303, 316 (2003), holding that public injunctive relief claims under California's Unfair Competition Law or Consumers Legal Remedies Act are not arbitrable (the *Broughton-Cruz* rule), and *Gentry v. Superior Court*, 42 Cal. 4th at 463, holding that arbitration agreements that prevent employees from vindicating statutory rights are unenforceable and in violation of California's public policy. See *Arguelles-Romero v. Superior Court*, 184 Cal. App. 4th 825 (2010) (applying the *Gentry* rule to pre-dispute consumer arbitration agreements). Some commentators have also suggested that California doctrines, such as unconscionability, remain valid defenses against the enforcement of arbitration provisions.

So while class action waivers appear to be valid and enforceable after *Concepcion*, the battle has shifted to focus on the enforceability of the arbitration agreement as a whole, with plaintiffs' attorneys seeking to preserve traditional defenses to the enforcement of arbitration agreements and defense counsel seeking a broad interpretation of *Concepcion*'s preemption analysis. *See* 131 S. Ct. 1740 (2011).

Numerous decisions have been published on the issue, exposing a tug-of-war in state and federal courts over *Concepcion*'s scope and breadth. For the most part, federal courts have adopted a broad interpretation (with the notable exception of the Second Circuit). Some state courts, and particularly California courts, have reasoned that *Concepcion*, and its progeny, should be construed narrowly, so that arbitration agreements can still be held unenforceable. This battle over the scope of *Concepcion* should soon be resolved, at least in California.

The California Supreme Court is poised to decide this issue in two cases, one in the employment context and the other in the consumer context. On April 3, 2013, the California Supreme Court heard oral argument in *Sonic-Calabasas A, Inc. v. Moreno*, No. S174475 (Cal. Apr. 3, 2013), a case in which the state high court will consider the reach of *Concepcion* in the employment context. In *Sonic-Calabasas A, Inc. v. Moreno*, 51

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Cal. 4th 659, 678-95 (2011), the California Supreme Court previously held: (1) an employee›s "statutory right to seek a Berman hearing [a wage hearing before the DLSE or Labor Commissioner], with all the possible protections that follow from it, is itself an unwaivable right that an employee cannot be compelled to relinquish as a condition of employment;" (2) waiver of an employee›s right to seek a Berman hearing is a substantively unconscionable contract term; and (3) the Federal Arbitration Act does not preempt the Court›s holdings on points one and two.

The Supreme Court of the United States granted review and vacated that decision, remanding the case for further consideration in light of *Concepcion*. *Sonic-Calabasas A, Inc. v. Moreno*, 132 S. Ct. 496 (2011).

The issues presented are as follows:

1. Can a mandatory employment arbitration agreement be enforced prior to the conclusion of an administrative proceeding conducted by the Labor Commissioner concerning an employee's statutory wage claim?

2. Was the Labor Commissioner's jurisdiction over employee's statutory wage claim divested by the Federal Arbitration Act (9 U.S.C. §2) under *Preston v. Ferrer*, 552 U.S. 346, 128 S. Ct. 978 (2008)?

After oral argument, some observers commented that the justices seemed to accept a broad reading of *Concepcion* in favor of enforcing arbitration agreements, but might allow the unconscionability doctrine to survive, though in some more limited fashion than the manner in which it has been applied in California. Given the California Supreme Court›s history in this area, it is likely that the high court will re-define the test or "factors" giving rise to unconscionability, but it is not likely to adopt a bright-line rule that the parties' agreements as to arbitration procedures are immune from unconscionability analysis. A decision should be issued this Summer.

Meanwhile, *Sanchez v. Valencia Holding Company*, California Supreme Court Case No. S199119, previously cited at 201 Cal. App. 4th 74 (2011) is fully briefed and ready for oral argument. According to the California Supreme Court's website, it will decide whether the Federal Arbitration Act (9 U.S.C. §2), as interpreted in *Concepcion*, 131 S. Ct. 1740, preempts state law rules invalidating mandatory arbitration provisions in a consumer contract as procedurally and substantively unconscionable. At issue there is the LAW form No. 553-CA-ARB (the version in circulation *before* July of last year).

As you may know, the LAW form No. 553-CA-ARB retail installment sale contract contains a pre-dispute class action waiver provision that protects automotive dealers from overreaching consumer attorneys seeking to require the dealer to buy back all sale contracts over a period of years for a mere formal or technical violation of the law, even when the dealer received no benefit from the violation.

Sanchez held that the arbitration provision in the LAW form No. 553-CA-ARB contract was unenforceable due to California's unconscionability doctrine. 201 Cal. App. 4th at

93. In *Sanchez*'s wake, consumer attorneys rushed into courts across California seeking to overturn previous orders compelling arbitration of disputes between car dealers and their customers and trying to force unreasonable settlements on dealers faced with daunting class action litigation. Since the California Supreme Court has granted review – effectively de-publishing the court of appeal's anti-dealer ruling – trial courts have not been consistent in ruling on dealers' motions to compel arbitration. And regardless of how the trial court rules on a dealer's motion to compel arbitration, the losing party routinely appeals that ruling, resulting in numerous stayed cases around the State, while everyone – consumer and dealer attorneys alike – collectively hold their breath, waiting for the California Supreme Court's decision in *Sanchez*.

As in *Moreno*, 51 Cal. 4th 659, the battle now turns to convincing the California Supreme Court that *Sanchez* should be reversed because, like the *Discover Bank* rule and the *Broughton-Cruz* rule, the *Sanchez* court's reasoning applies California's state laws and public policy in a manner that disfavors arbitration and is preempted by the Federal Arbitration Act (FAA). *See Broughton v. Cigna Healthplans*, 21 Cal. 4th 1066 (1999); *see Cruz v. Pacificare Health Systems, Inc.*, 30 Cal. 4th 303 (2003).

Since the court of appeals' *Sanchez* decision, the Ninth Circuit weighed in with *Kilgore v. KeyBank, N.A.*, 673 F.3d 947, 963 (9th Cir. Cal. 2012), wherein it held that California's *Broughton-Cruz* rule is preempted by the FAA under *Concepcion*. That decision was taken by the Ninth Circuit *en banc*.

On April 11, 2013, the Ninth Circuit issued its *en banc* decision in *Kilgore v. Keybank, National Association*, No. 09-16703, declining to resolve whether the FAA preempts California's *Broughton-Cruz* rule prohibiting arbitration of injunctive relief claims. *Kilgore v. KeyBank, N.A.*, 2013 WL 1458876 (9th Cir. Cal. Apr. 11, 2013) (en banc). While the *Broughton-Cruz* rule likely did not survive *Concepcion*, *Kilgore* gives further fodder for the plaintiffs› argument in *Sanchez*.

Central to the en banc panel's decision in *Kilgore* was the fact that the bank was no longer engaged in the purportedly unlawful activity, so there was no need for an injunction to stop the supposed illegal practice. *Kilgore*, 2013 WL 1458876 at *19-20. This allowed the court to duck the issue – reasoning that if there is no conduct to enjoin, there is no need to determine whether public policy prohibits arbitration of a claim seeking to enjoin such conduct. *Id.* By ducking the issue, the court avoided the central question in the case.

But public policy rules like the *Broughton-Cruz* rule and the *Gentry* rule have been struck down in other jurisdictions as pre-empted by the FAA under *Concepcion*. For example, in *Marmet Health Care Center, Inc. v. Brown*, 132 S. Ct. 1201, 1203-04 (2012) (per curiam), the United States Supreme Court, in a Per Curiam decision, overruled a similar West Virginia Supreme Court rule refusing to enforce a pre-dispute arbitration agreement governed by the FAA based on a state public policy, holding West Virginia's public policy was preempted by the FAA.

And the U.S. Supreme Court has since reminded other courts of its "emphatic federal policy in favor of arbitral dispute resolution." *KPMG LLP v. Cocchi*, 132 S. Ct. 23, 25 (2011). There, the U.S. Supreme Court reversed the Florida Court of Appeal's decision to invalidate an arbitration agreement on the grounds that it found only some of the claims at issue were subject to arbitration. *Id.* at 26. In doing so, the Supreme Court emphasized that under the FAA, arbitration agreements "must be enforced in state and federal courts," and that state courts "have a prominent role to play as enforcers of agreements to arbitration." *Id.* at 24. This dispels any doubt as to whether *Concepcion* is applicable in state court.

It is also promising that the U.S. Supreme Court may determine whether the concept of "vindication of statutory rights" trumps the FAA in deciding whether to enforce a class action waiver when those statutory rights can only be pursued in litigation. The case is *In re American Express Merchants Litigation*, Case No. 12-133 (cert. granted November 9, 2012) ("AMEX Merchants"). Twice before, the U.S. Supreme Court struck down the Second Circuit's holding invalidating the class action waiver in that case. Oral argument was recently heard and a decision is expected soon.

In the meantime, however, the supreme courts of other states have also been limiting enforcement of arbitration agreements on unconscionability grounds. For example, addressing some of the same concerns raised by the consumer in *Sanchez*, earlier this year, in *Gandee v. LDL Freedom Enterprises, Inc.*, 176 Wn. 2d 598, 605-09 (2013), the Washington Supreme Court invalidated a pre-dispute consumer arbitration agreement (not in the context of a motor vehicle purchase) on the grounds that the consumer's showing of inability to pay the costs of arbitration was sufficient and the "loser pays" provision "effectively chills [the borrowers] ability to bring suit under [Washington's consumer protection statute]." *Id.*

Based on recent circuit court and SCOTUS holdings, made in the wake of *Concepcion*, dealers and other retailers should remain hopeful that *Moreno*, 51 Cal. 4th 659, and Sanchez, 201 Cal. App. 4th 74, will be reversed and the California Supreme Court will rule consistent with *Concepcion* that generally available contract defenses cannot be used to invalidate otherwise enforceable arbitration agreements under the FAA, unless that contract defense is used in a manner that does not disfavor arbitration. But in the event that it does not rule in favor of dealers, the last stop on the train, the SCOTUS, may be where dealers obtain an ultimate victory on this issue, particularly due to the hesitancy of state supreme courts to invalidate their own public policies and ignore the large body of law developed around unconscionability in arbitration agreements – regardless of its overall impact of disfavoring enforcement of arbitration agreements.

In the meantime, care should be taken in drafting arbitration agreements, particularly in connection with cost or fee shifting provisions and the scope of claims covered under the arbitration agreement. ■