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U.S. Supreme Court: FAA Preempts State Law Rule That a Class Action Waiver in a Consumer Arbitration Clause Is Unconscionable

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In *AT&T Mobility, LLC v. Concepcion*, No. 09-893, — U.S. — (Apr. 27, 2011), the U.S. Supreme Court held in a 5-4 decision that the Federal Arbitration Act (FAA) prohibits states from conditioning the enforceability of consumer arbitration agreements on the availability of classwide dispute resolution procedures. The Court's decision in *Concepcion* will have potentially profound effects on the future of certain types of class action litigation, including litigation outside the consumer class action context. In endorsing in the strongest terms the federal policy favoring arbitration embodied in the FAA, the Court seriously undermined—if not overruled—numerous decisions that have voided as unconscionable class and collective action waivers in arbitration agreements. The ruling in *Concepcion* provides defendants with powerful arguments that the FAA requires enforcement of class action waivers in arbitration agreements, and thus may enable parties to reduce significantly their exposure to class action liability through properly drafted arbitration agreements.

Background

The Concepcions purchased cellular telephone service from AT&T. Their contract with AT&T provided for arbitration of all disputes between the parties, and required that claims be brought in the parties' "individual capacity, and not as a plaintiff or class member in any purported class or representative proceeding." The arbitration agreement featured terms that the district court described as notably consumer friendly. Among other things, AT&T agreed to pay all costs for nonfrivolous claims; allowed the consumer to choose whether the arbitration would take place in person, by telephone, or through written submissions; and provided that the arbitrator could award any form of individual relief. The agreement also precluded AT&T from seeking attorney's fees and, in the event that the customer received an arbitration award greater than the amount of AT&T's last settlement offer, required AT&T to pay a minimum award of $7,500, plus twice the claimant's attorney's fees.

The Concepcions sued AT&T in the U.S. District Court for the Southern District of California, alleging that AT&T violated California consumer protection statutes by charging sales tax on mobile phones that had been advertised as free. The Concepcions alleged they suffered damages of $30.22—the amount of the sales tax. AT&T moved to compel individual arbitration of the Concepcions' claims. The district court denied the motion. Relying on the California Supreme Court's decision in *Discover Bank v. Superior Court*, 113 P.3d 1100 (Cal. 2005), the lower court found the arbitration provision was unconscionable because AT&T had not shown that individual arbitration adequately substituted for the deterrent effects of class actions. In *Discover Bank*, the California Supreme Court held that class action waivers in consumer arbitration agreements are unconscionable in cases that involve adhesion contracts,

predictably small amounts of damages, and allegations of consumer fraud, because such waivers, in violation of California law, effectively permit a defendant to exculpate itself against its own fraud.

The Ninth Circuit Court of Appeals affirmed the district court's denial of AT&T's motion to compel arbitration. It also held that the *Discover Bank* rule was not preempted by the FAA because that rule was an application of general principles of California unconscionability law.

Concepcion: A State Law Rule That Frustrates the Purposes of the FAA Is Preempted

In reversing the Ninth Circuit, the Supreme Court proceeded from the principle that "[t]he overarching purpose of the FAA . . . is to ensure the enforcement of arbitration agreements according to their terms so as to facilitate streamlined proceedings." The Court noted it had long construed Section 4 of the FAA, which requires courts to compel arbitration "in accordance with the terms of the agreement," to permit parties to structure their arbitration agreements as they see fit, such as by limiting the issues subject to arbitration, arbitrating according to specific rules, and limiting the persons with whom the parties will arbitrate their disputes. The Court found that the *Discover Bank* rule interferes with the FAA's purpose of promoting arbitration because it effectively forces the parties into classwide arbitration proceedings, thus "sacrific[ing] the principal advantage of arbitration—its informality" for a procedure that is slower, costlier, and more complex.

The Court rejected the argument that California unconscionability law, as interpreted by *Discover Bank*, is a generally applicable defense to contract formation and thus not preempted by the FAA. Moreover, the Court stated, even a generally applicable rule of state contract law must yield to the FAA if the state-law rule "stand[s] as an obstacle to the accomplishment of the FAA's objectives" of promoting arbitration and ensuring that arbitration agreements are enforceable according to their terms.

Implications

The full implications of the *Concepcion* decision are uncertain (and likely will be the subject of extensive litigation), but they are apt to be significant. Although the Court's decision focused on California law, courts in numerous states have held class action and class arbitration waivers unconscionable, and therefore unenforceable, on grounds similar to the *Discover Bank* rule. *Concepcion* may overrule any decision that held a class action waiver in arbitration unconscionable on the basis that the waiver is presented in an adhesion contract and prevents consumers or other plaintiffs from aggregating small claims. A clearly stated class arbitration waiver will probably be enforceable.

Also, while *Concepcion* involved a consumer arbitration agreement, the decision is likely to have broader application. For example, the Court specifically mentioned the employment context, noting it had previously upheld arbitration agreements "despite allegations of unequal bargaining power between employers and employees." This suggests that a class action waiver in an employment agreement is likely to be enforced as well.

To be sure, the *Concepcion* decision raises many questions as well. As noted, AT&T's arbitration agreement had many consumer-friendly features. One issue is whether a class waiver would be enforceable in an arbitration agreement that is less consumer friendly (for example, one that does not allow the arbitrator to award punitive damages, or requires the parties to split the cost of arbitration). In such cases, costs and fees could easily exceed the value of the claim. Nevertheless, the Supreme Court's analysis did not expressly turn on these consumer-friendly features, although the Court did highlight the district court's observation that the guaranteed damages amounts would have put the Concepcions in a substantially better position than if they were participants in a class action.

Also, the *Concepcion* decision addressed just one basis for holding a class waiver unenforceable—state unconscionability law. Left open is whether a court may refuse to enforce a class waiver on some other basis, such as where a class waiver would undermine the vindication of an unwaivable statutory right, *see Gentry v. Superior Court*, 165 P.3d 556 (Cal. 2007), or where the expert costs necessary to prove a claim effectively preclude an individual claim, *see In re American Express Merchants' Litig.*, 634 F.3d 187 (2d Cir. 2011). Although the broad language in *Concepcion*, and its vigorous emphasis on the enforceability of arbitration agreements according to their terms, suggests that its holding may cover these situations as well, further litigation will undoubtedly define the contours of the *Concepcion* decision.

In light of this landmark decision, companies and employers should promptly review the terms of their consumer, commercial, and employment contracts. Companies and employers with existing arbitration agreements should carefully examine them to determine whether modifications are necessary to gain the full benefit of *Concepcion.* Employers that do not currently use arbitration agreements will need to carefully weigh the pros and cons of arbitration of individual claims in deciding whether to adopt arbitration in order to have an enforceable class action waiver. Companies that have not used arbitration agreements (or have not used class waivers) in their consumer-facing agreements should strongly consider adding them, because *Concepcion* provides a mechanism for significantly reducing, if not eliminating, class action risk. Morgan Lewis attorneys have been monitoring these trends for years and have helped many companies and employers draft such arbitration agreements in keeping with the latest developments. Please contact any of the individuals listed below or your normal Morgan Lewis contact for assistance in reviewing contracts or including appropriate arbitration clauses.

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