

## Calif. Unconscionability Analysis In Conflict With FAA

*Law360, New York (November 20, 2013, 7:21 PM ET)* -- The California Supreme Court has a long history of inventing new rules to invalidate consumer and employment arbitration agreements. Most notably, in 2005, that court announced a new unconscionability rule — the discover bank doctrine — that effectively blocked enforcement of every consumer arbitration agreement that did not permit class procedures. But the U.S. Supreme Court’s landmark decision in *AT&T Mobility LLC v. Concepcion* held that the Federal Arbitration Act (“FAA”) preempted the discover bank rule.

Will the California Supreme Court faithfully apply *Concepcion* and the U.S. Supreme Court’s other recent arbitration decisions? Or will it try to formulate new grounds for prohibiting arbitration, requiring the high court to intervene yet again to vindicate the FAA’s “liberal federal policy favoring arbitration agreements, notwithstanding any state substantive or procedural policies to the contrary.” With four significant arbitration cases now pending before the California Supreme Court, we are likely to find out in the next 12 to 24 months.

The first of these decisions, handed down last month in *Sonic-Calabasas A Inc. v. Moreno*, contains a distinctly mixed message. In response to the U.S. Supreme Court’s order remanding the case in light of *Concepcion*, the California court overturned its own prior ruling invalidating the arbitration agreement, correctly holding that its original rationale could not stand. In an opinion by Justice Goodwin Liu, the court went on to discuss — although not explicitly mandate — a brand-new approach to unconscionability analysis that reintroduces the precise legal principle that the U.S. Supreme Court held preempted in *Concepcion* and rejected again this year in *American Express Co. v. Italian Colors Restaurant*. And it does so through an unconscionability standard specially constructed to apply only to arbitration contracts, notwithstanding the FAA’s express preemption of arbitration-specific contract enforcement standards.

What will *Sonic*’s effect be? The court’s musing about unconscionability doctrine is not tethered to any holding, because the court specifically leaves the question of unconscionability for determination on remand. And the court repeatedly says that its new analysis is simply “one factor” that could be considered in the unconscionability inquiry.

Even more important, the majority's musing does not actually require a lower court to do anything in any particular case. As Justice Corrigan, who joined the majority, explained in her concurring opinion, the decision "does not require trial courts to adopt a new procedure or analytic approach"; rather "[c]onsiderations outlined in the majority's opinion may be relevant to [unconscionability] analysis, but lower courts retain discretion to weigh these considerations as appropriate in each particular case." That qualification is important, because if a California court were to apply this new test to invalidate an arbitration agreement, that ruling plainly would be subject to reversal on the ground that such state-law rulings are preempted on multiple grounds by the FAA.

In short, for the reasons we discuss below, if the California courts do not heed these warnings, that state's law of unconscionability is on track for a return trip to the U.S. Supreme Court.

## **Sonic's Background**

Sonic involved an employment arbitration agreement. The employee filed a claim for unpaid vacation pay with the state labor commissioner, invoking an administrative procedure known as the "Berman hearing," which is an alternative to instituting an action in court.

In its initial decision, the California Supreme Court refused to require arbitration, holding that a party dissatisfied with the outcome of the Berman hearing could then seek a de novo determination in arbitration (paralleling the statutory right to a de novo determination in court). The court held that substituting arbitration for the Berman hearing rendered the arbitration agreement unconscionable, because the agreement constituted a waiver of the employee's statutory "right" to a Berman hearing. The court thus adopted an across-the-board rule effectively prohibiting arbitration of claims when an employee had invoked the Berman procedures.

In Oct. 2011, the U.S. Supreme Court vacated and remanded Sonic for reconsideration in light of *Concepcion*.

## **Categorical Prohibition of Arbitration Abandoned**

The California Supreme Court reversed its prior decision, concluding that "[i]n *Concepcion*, the high court clarified the limitations that the FAA imposes on a state's capacity to enforce its rules of unconscionability on parties to arbitration agreements." Because "compelling the parties to undergo a Berman hearing would impose significant delays in the commencement of arbitration" and "'efficient, streamlined procedures' is a fundamental attribute of arbitration with which state law may not interfere," the prior Sonic ruling could not stand: "[W]e now hold, contrary to Sonic, that the FAA preempts our state-law rule categorically prohibiting waiver of a Berman hearing in a pre-dispute arbitration agreement imposed on an employee as a condition of employment."

But the court did not stop there.

Concluding that the employee in Sonic had also argued that the arbitration agreement was unconscionable, the California Supreme Court directed the superior court to address the unconscionability issue on remand.

If the California Supreme Court had ended its opinion at that point, there would be no question regarding its compliance with the U.S. Supreme Court's rulings. But the California court instead embarked upon on a wideranging discussion of unconscionability doctrine in the context of arbitration agreements. That is where the court went astray.

## A New Unconscionability Doctrine For (Some) Arbitration Agreements?

The starting point for the California court's discussion was correct — arbitration agreements are subject to unconscionability standards as long as those standards also apply to other types of contracts. But the new mode of unconscionability analysis identified in *Sonic* is unique — it is unlike the unconscionability test that California courts apply in every other context.

*Sonic* says that, although the arbitration agreement's elimination of the Berman administrative procedures cannot by itself bar enforcement of the arbitration agreement, a court may evaluate the dispute resolution process specified in the arbitration agreement against the Berman procedures in order to determine whether the arbitration agreement provides a similarly "effective and low-cost approach to resolving wage disputes." If the arbitration process falls short of the Berman procedures, that is "one factor" that a court may consider in the unconscionability inquiry, "although that factor alone does not necessarily render the agreement unconscionable."

As a threshold matter, it is important to recognize the limited scope of the court's new principle: it applies only where a legislature has created a special administrative procedure for adjudication of a specified category of claims. But in that limited context, the *Sonic* court claimed that its new approach was no different than other sorts of unconscionability rules that have been applied to arbitration agreements — such as invalidating agreements that require an employee or consumer to pay arbitration filing fees or arbitrator costs that greatly exceeded court filing costs, confer on the party with superior bargaining power the right to select the arbitrator, limit the amount of damages recoverable in arbitration, or give only the party with superior bargaining power the right to recover attorneys' fees if it prevails.

In fact, there are several significant differences between the *Sonic* court's new approach and past unconscionability rulings.

First, all of these other rulings involved arbitration rules that applied across-the-board to all arbitrations conducted under the agreement. That is critically important: under California law the unconscionability determination must be made as of "the time [the contract] was made" (Cal. Civil Code 1670.5(a)). Because those provisions applied regardless of the claim to be arbitrated, their adverse effect was clear at the time the contract was signed.

Here, by contrast, the claimed unfairness relates to only one of the many types of claims that an employee could adjudicate under the arbitration agreement, and to none of the claims that an employer might seek to adjudicate. A finding of unconscionability could be based on claimed unfairness in the adjudication of a claim for withheld pay only if — at the time the contract was signed — it was (a) extremely likely that such a claim would arise and (b) any supposed unfairness in the method of resolving withheld pay claims, as compared to the Berman procedures, was not counterbalanced by benefits conferred on employees from the availability of arbitration to resolve claims that the employee would have to assert or defend in court. (In addition, of course, the employee would have to show that the Berman procedures were more effective than arbitration — a question that was hotly disputed before the court and as to which the court took no position.) It seems highly unlikely that an employee would be able to make the necessary showing. In fact, when the full panoply of claims that an employee could bring against an employer are considered — including claims for wrongful termination in California and claims under antidiscrimination statutes — there is significant evidence that employees fare better in arbitration than in court.

By focusing its discussion only on the arbitration/Berman procedure comparison, the Sonic court created the misimpression that a court could base an unconscionability determination solely or in large part on the finding that the arbitration procedures fell short. But such a determination would violate California's unconscionability law.

Second, the supreme court's unconscionability discussion appears to encourage opponents of arbitration clauses to argue that even a relatively small difference in the perceived effectiveness and cost of the arbitral procedures, as compared to the Berman procedures, could suffice to establish at least a partial basis for invalidating the arbitration agreement. As the majority opinion put it, the "loss of [the] benefit" of the Berman procedures "may be one factor in an unconscionability analysis."

But if courts were to place weight on the absence of Berman procedures in arbitration, that approach would work a sea change in California law. In contexts other than arbitration, courts have found a contract unconscionable only if it "shocks the conscience." And even in the arbitration context, California courts have applied that test, albeit not consistently. Basing an unconscionability finding on a lesser standard would conflict with a long line of California cases — something that the justices who concurred in part and dissented in part in Sonic pointed out. Indeed, although the majority declined to reconcile the different formulations of "unconscionability," Justice Carol Corrigan forthrightly stated in her concurrence that "the proper test for determining unconscionability here is whether the terms are so one-sided as to 'shock the conscience.' Courts are not free to alter terms to which the contracting parties agreed simply because they find the terms unreasonable or ill-advised. The unconscionability test requires a much stronger showing of unfairness."

Because the Sonic opinion focuses solely on differences between the arbitral procedures and the Berman procedures — and therefore fails to place its unconscionability discussion in the context of California's generally applicable standard for finding unconscionability — the opinion might be read, mistakenly, to convey the impression that any deviation from the Berman procedures would inexorably lead to a finding of unconscionability. But the court could not, and did not, overturn the State's settled standards for making that determination, and those standards leave no doubt that such a deviation could never by itself justify an unconscionability determination.

### **Any Unconscionability Holding Based On This New Approach Would Violate The FAA**

If — in the context of a claim for unpaid wages — a court were to base a finding of unconscionability on the differences between the process specified in an arbitration agreement and the Berman procedures, the FAA would preempt that application of state law to the same extent, and for the same basic reasons, that the FAA preempts California's discover bank rule.

In *Concepcion*, the U.S. Supreme Court held that a state-law unconscionability rule that "interferes with fundamental attributes of arbitration" is preempted because that rule "creates a scheme inconsistent with the FAA." The high court concluded that conditioning enforcement of an arbitration agreement on the availability of class procedures violates that principle.

In *Sonic*, the California Supreme Court acknowledged the principle, but concluded that the principle would not be violated by refusing to enforce an arbitration agreement unless it specified dispute-resolution procedures equivalent to those that were otherwise required by state law for adjudication of the particular claim. Pointing to the U.S. Supreme Court's identification of informality, lower cost, greater speed and efficiency and use of expert adjudicators as key attributes of arbitration, the California court stated that its new approach "will, if anything, tend to promote the FAA's objectives rather than lead to any increase in cost, procedural rigor, complexity, or formality."

But the California court's analysis ignores the critical fact that one of the "fundamental attributes of arbitration" that the FAA protects is — in the words of the Concepcion opinion — that the parties "may agree ... to arbitrate according to specific rules"; "[t]he point of affording parties discretion in designing arbitration processes is to allow for efficient, streamlined procedures tailored to the type of dispute" (emphasis added).

Basing a finding of unconscionability on the California court's new test would interfere directly with the FAA's protection of the freedom to tailor appropriate arbitral procedures. The court asserted that there was no interference with the fundamental attributes of arbitration because the court concluded that the Berman procedures promote the same objectives as arbitration: efficiency, informality, low cost and speed. But the court's approach would (a) preclude parties from adopting procedures that embody a more efficient and informal approach than the Berman procedures; (b) require the adoption of multiple procedures, as discussed above; and (c) require parties to adopt complex procedures if a statute specifies a special dispute-resolution system that embodies detailed formal procedures for resolution of a particular sort of state-law claim. All three of these consequences interfere with the fundamental principle that parties may design the dispute-resolution procedures that will be used in arbitration.

Indeed, the California court's contrary conclusion is based on the very reasoning that the U.S. Supreme Court rejected in both *Concepcion* and *American Express*. The plaintiffs in those cases argued that the absence of class action procedures would prevent the "effective vindication" of the underlying statutory right, and the court in each case held the argument irrelevant to FAA preemption analysis. In *Concepcion*, the court explained that "[t]he dissent claims that class proceedings are necessary to prosecute small-dollar claims that otherwise might slip through the legal system. .... But states cannot require a procedure that is inconsistent with the FAA, even if it is desirable for unrelated reasons." And in *American Express*, the court held that "the fact that it is not worth the expense involved in proving a statutory remedy does not constitute the elimination of the right to pursue that remedy."

The *American Express* dissenters made the point even more clearly: "When a state rule allegedly conflicts with the FAA, we apply standard preemption principles, asking whether the state law frustrates the FAA's purposes and objectives. If the state rule does so — as the court found in *AT&T Mobility* — the Supremacy Clause requires its invalidation. We have no earthly interest (quite the contrary) in vindicating that law. Our effective-vindication rule comes into play only when the FAA is alleged to conflict with another federal law."

Here, the California Supreme Court expressly invoked the discredited form of "effective vindication" theory, stating that its new unconscionability test requires an arbitration agreement "to provide for accessible, affordable resolution of wage disputes" as measured by a comparison between the arbitral procedures and a state's specified litigation or administrative procedures. That is the precise rationale that the U.S. Supreme Court has recognized to be preempted under the FAA.

The two justices in *Sonic* who dissented from the majority's unconscionability discussion explained that, under *American Express*, the FAA precludes "the very process the majority prescribes for determining the accessibility and affordability of the arbitration procedure in a particular case," because "[s]uch a preliminary litigating hurdle ... would undoubtedly destroy the prospect of speedy resolution that arbitration in general and bilateral arbitration in particular was meant to secure."

Finally, the California Supreme Court tried to bolster its antipreemption argument by asserting that California could, consistent with the FAA, adopt an “unwaivable statute” that required a set of procedures mirroring the exceptionally pro-consumer AT&T arbitration provision at issue in *Concepcion*. Although the goal of such a statute would be “to achieve the same objective as a rule forbidding class waivers” by mandating the same procedural regime as the AT&T arbitration provision, the court asserted that such a statute nevertheless would be valid because it did not “somehow circumvent the FAA’s preemption of state-law rules forbidding class waivers.”

But such a statute would suffer from the same fatal flaw as an unconscionability ruling based on the California court’s new test: it would significantly limit the discretion to determine arbitral procedures protected by the FAA, effectively imposing a procedural requirement that defendants make settlement offers in virtually all arbitrations to avoid the potential penalties imposed if a defendant fails to do so. It is true, of course, that many companies have made a choice to adopt procedures like the ones in AT&T’s arbitration provision — but that does not mean that a state can mandate those procedures as a condition of enforcing arbitration without running afoul of the FAA.

## Conclusion

For its first major decision on arbitration since *Concepcion*, the California Supreme Court earns a decidedly mixed grade. Although correcting its most egregious error in the prior *Sonic* opinion, it nonetheless adopted a new, arbitration specific approach to unconscionability that raises more questions than it answers, and that threatens to mire the state courts in multiple rounds of litigation and appeals over the enforceability of arbitration agreements in wage-and-hour cases. One can only hope that the state court will do a better job in the three remaining arbitration cases than it has so far of faithfully applying the U.S. Supreme Court’s FAA precedents.

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