California Supreme Court: Federal Arbitration Act Preempts Plaintiff's State Rights

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An arbitration clause in a consumer agreement was enforceable, including the class action waiver, despite four supposedly one-sided arbitration provisions in the agreement, the California Supreme Court has held. *Sanchez v. Valencia Holding Co., LLC*, No. S199119 (Aug. 3, 2015). The much-anticipated decision has significant implications for arbitration agreements between employers and employees.

Background

In 2011, the U.S. Supreme Court ruled in *AT&T Mobility v. Concepcion,* 131 S.Ct. 1740 (2011), that the Federal Arbitration Act preempts state laws that limit the availability of arbitration. The U.S. Supreme Court had struck down California's ban on class action waivers in consumer arbitration agreements. *Concepcion* has since been applied in the employment context. *See Iskanian v. CLS Transportation, Inc.,* 59 Cal.4th 348 (2014).

The unconscionability doctrine continues to allow courts under state contract law to invalidate unfairly one-sided contracts. In deciding whether to enforce an arbitration agreement, California courts examine whether its terms are both procedurally and substantively unconscionable.

Concepcion held that while generally applicable state law contract defenses, such as fraud, duress, or unconscionability remain grounds for invalidating an arbitration agreement under the FAA, this is so only where they are enforced evenhandedly, applied to all types of contracts, and do not "interfere[] with fundamental attributes of arbitration."

Lower Courts' Decisions

In *Sanchez*, a putative class action, the trial court refused to compel arbitration under a car purchase agreement. It held the class waiver unenforceable on the ground that the state Consumer Legal Remedies Act ("CLRA," Civil Code §§ 1750-1784) expressly provides for class action litigation and declares the right to a class action to be unwaivable. Because the arbitration clause provided that "[i]f a waiver of class action rights is deemed or found to be unenforceable for any reason in a case in which class action allegations have been made, the remainder of this Arbitration Clause shall be unenforceable," the court denied the motion to compel arbitration.

The Court of Appeal did not address the enforceability of the class action waiver. It instead invalidated the arbitration provision in the agreement because it found four provisions to be unfairly one-sided in the seller's favor: (1) the parties could appeal the arbitral decision to a three-arbitrator panel if the award was $0 or more than $100,000; (2) the parties could appeal the grant of injunctive relief but not the denial of it; (3) the appealing party must pay in advance the arbitration costs associated with the appeal; and (4) self-help remedies, such as repossession, were exempted from arbitration.

California Supreme Court Decision

The California Supreme Court disagreed with the Court of Appeal, reversing the lower court decision in full.

For a contract to be "unconscionable," the Supreme Court said, there must be "procedural" unconscionability, which focuses on oppression or surprise due to unequal bargaining power. There also must be "substantive" unconscionability, which courts have used various terms to describe, including "overly harsh," "unduly oppressive," "unfairly one-sided," and "so one-sided as to shock the conscience." The Court reaffirmed that these terms mean the same thing — a contract is substantively unconscionable where there is unfairness beyond a "simple old-fashioned bad bargain."

The Court emphasized that an "evaluation of unconscionability is highly dependent on context." The unconscionability doctrine requires inquiry into the "commercial setting, purpose, and effect" of the contract. This, the Court explained, gives the party with superior bargaining strength a type of extra

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protection for which it has a commercial need without being unconscionable. (*Quoting Armendariz v. Foundation Health Psychare Services, Inc.,* 24 Cal.4th 83, 117 (2000).)

Applying these principles, the Court held that the FAA preempts a plaintiff's right to class action procedures under the CLRA. This is important because, to the extent other state laws provide for the right to class action procedures, they too will be preempted.

The Court also found each of the four supposedly one-sided arbitration provisions in the purchase agreement relied upon by the lower court to reject the agreement enforceable in the business context at hand — a car purchase.

Moreover, the Court upheld a provision allowing an appeal of an arbitral grant of injunctive relief, even though this tended to favor the car dealership. The Court reasoned that the seller had a legitimate business concern justifying the one-sidedness of the term — the scope of an injunction can extend well beyond the transaction at issue, compelling the seller to change its business practices. This potentially far-reaching remedy justifies the extra protection the term provides, it ruled. Similarly, employers often exempt from their arbitration agreements claims for injunctive relief needed to protect trade secrets or other confidential information. *Sanchez* may justify this type of one-sidedness if the employer can demonstrate a legitimate business need.

The Court held that a carve-out of dealer self-help remedies, such as repossession, likewise was not impermissible given that both the California Arbitration Act and federal law allow a party to seek provisional remedies in court, such as preliminary injunctions, to preserve the status quo without waiving the right to arbitration. (Code Civ. Proc. § 1281.8(b); *Toyo Tire Holdings v. Continental Tire North Amer.,* 609 F.3d 975, 981 (9th Cir. 2010).) The Court determined that this carve-out was not unconscionable because "it is undisputed that the remedy of repossession…is an integral part of the business of selling automobiles on credit and fulfills" a "'legitimate commercial need.'" (*Quoting Armendariz*, 24 Cal.4th at 117.) Employers should be prepared to explain specifically how arbitration agreement carve-outs serve a legitimate commercial need for their business.

The Court upheld the other two challenged provisions, as well, based on the context. The ability to appeal awards of $0 or more than $100,000 is not unreasonable, the Court said, given that most disputes involving a car purchase will result in awards between these two outliers. Moreover, the fact that the appealing party must pay for the costs of such an appeal, the Court stated, is not necessarily unfair given indigent consumers do not pay arbitration fees (Code Civ. Proc. § 1284.3), and a court may use the unconscionability doctrine on a case-by-case basis to protect non-indigent consumers. This aspect of the opinion again makes clear that arbitration contracts are to be evaluated on a case-by-case basis according to the context, which could be helpful to employers.

Employers should consider reviewing their employment agreements with counsel to ensure the agreements are enforceable. Jackson Lewis attorneys are available to answer inquiries regarding this case and assist employers.