Contracts Tea no. 3 (May 2011)

US Supreme Court ruled that *Discover Bank* rule prohiting class waivers in adhesion contracts as always uncosconscionable, cannot stand the FAA's preemption. The decision, beside leaving open the issue whether unconscionability of such waivers must be evaluated case by case or whether such waivers may never be unconscionable, opens up the possibility of a complete disappearance of class actions in consumer contracts.

On April 27, 2011, the Supreme Court decided 5-4 (opinion of Justice Scalia) *AT&T Mobility v. Concepcion*,[1] holding that "[b]ecause it stands as an obstacle to the accomplishment and execution of the full purposes and objectives of Congress . . . California's Discover Bank rule is pre- empted by the FAA."

In *Discover Bank v. Superior Court*[2], the California Supreme Court had held that "class waivers" in consumer arbitration agreements are unconscionable if the agreement is in an adhesion contract, disputes between the parties are likely to involve small amounts of damages, and the party with inferior bargaining power alleges a deliberate scheme to defraud.

In February 2002, Vincent and Liza Concepcion signed a contract for the sale and servicing of cellular telephones with AT&T Mobility LCC, Cingular at the time ("AT&T"). As part of the contract, they were given "free" phones. However, they were charged $ 30.22 for sales taxes. The service contract with AT&T contained a clause that stated that any disputes between AT&T and its customers must be settled through arbitration, and that customers could not arbitrate as a class.[3]

---

[1] 563 U.S. ___ (2011).

Slip opinion available at http://www.supremecourt.gov/opinions/10pdf/09-893.pdf.

[2] 36 Cal. 4th 148, 113 P.3d 1100 (2005).

[3] In particular the contract provided arbitration be brought in the parties' "individual capacity, and not as a plaintiff or class member in any purported class or representative proceeding."

In March 2006, the Concepcions filed a complaint against AT&T in the United States District Court for the Southern District of California for false advertising and fraud (for charging sales taxes on phones it advertised as free). The complaint was later consolidated with a putative class of similarly over-charged AT&T customers. AT&T moved to compel arbitration while the plaintiffs opposed the motion, contending that the arbitration agreement was unconscionable and unlawfully exculpatory under California law because it disallowed classwide procedures.

The District Court found the provision unconscionable based on the *Discover Bank* rule. The Ninth Circuit affirmed, still relying on *Discover Bank* and holding that the rule stated in *Discover Bank* was not preempted by the Federal Arbitration Act ("FAA") because it was simply a specification of the unconscionability analysis applicable to contracts generally.

The Supreme Court reversed. The way in which the Supreme Court formulated the issue -- "whether §2 preempts California's rule classifying most collective-arbitration waivers in consumer contracts as unconscionable" -- allowed the Court to transform an issue of unconscionability into an issue of preemption of state law by federal law. Relying on its previous decisions of *Moses H. Cone Memorial Hospital v. Mercury Constr. Corp.*,[4] *Rent-A-Center, West, Inc. v. Jackson*,[5] and *Buckeye Check Cashing, Inc. v. Cardegna*,[6] the Court emphasizes that the FAA is expression of a favor towards arbitration, that arbitration is a matter of contract and that arbitration agreement stands on a equal footing as any other contract.[7] The Court reminds that FAA is federal law, and as such, preempts state law. Because the FAA was designed to promote arbitration,[8] "[r]equiring the availability of classwide arbitration interferes with fundamental attributes of arbitration and thus creates a scheme

---

[4] 460 U. S. 1, 24 (1983).

[5] 561 U. S. _ , _ (2010)

[6] 546 U. S. 440, 443 (2006).

[7] Slip opinion at 7,8.

[8] Slip opinion at 11.

inconsistent with the FAA."[9] "The conclusion follows that class arbitration, to the extent it is manufactured by Discover Bank rather than consensual, is inconsistent with the FAA."

We agree: a state law that would *require* class arbitration would be inconsistent with the FAA and therefore preempted.[10]

Our problem is that we have the clear impression that the Supreme Court is telling us something more, i.e. that class arbitrations are always inappropriate.[11] In fact, the Supreme Court seems to say that class waivers in arbitration agreements are *never* unconscionable because class action does not make sense in arbitration. That would go against Section 2 of FAA that permits arbitration agreements to be declared unenforceable "upon such grounds as exist at law or in equity for the revocation of any contract." And it would be a clear contradiction of the precedents of the Court that provided that arbitration is on the same footing of the other contracts[12] (not better off).

But there is something more to say: if it is true that *AT&T Mobility* is telling us that class action in arbitration does not make

---

[9] Slip opinion at 9. For the Supreme Court, "[a]lthough the rule does not require classwide arbitration, it allows any party to a consumer contract to demand it ex post."

[10] We do not take position on the California Supreme Court's assertion that its holding in *Discover Bank* was simply an application of the general rule on unconscionability that is allowed by Section 2 of FAA. We do not take position but let us say that it would make a lot of sense.

[11] Slip opinion 14-16 *passim*.

[12] *Buckeye Check Cashing, Inc. v. Cardegna.*

sense,[13] then the insertion of an arbitration agreement in a contract would be an effective insurance for a company against the risk of contractual class actions in general. Why? If a class action waiver cannot be unconscionable, then no class action can be brought in arbitration. In addition, class actions could not be brought in court because arbitration is exclusive.

What if the arbitration agreement is silent on arbitration? *AT&T Mobility* does not address this question. Justice Scalia does say: "The conclusion follows that class arbitration, *to the extent it is manufactured by Discover Bank rather than consensual*, is inconsistent with the FAA." In fact, in *Green Tree Financial Corp. v. Bazzle*, 539 U.S. 444 (2003), the Court held that when an arbitration agreement was silent on class actions, the arbitrator had the authority to allow a class action. Interestingly, Justice Scalia, the author of the opinion in *AT&T Mobility,* joined in the majority in that case.

New York Court of Appeals explains the boundaries of the *Mohawk* doctrine, excluding from it passive participation in someone's effort to procure clients.

Under New York law a seller of a business that includes the

---

[13] "Arbitration is poorly suited to the higher stakes of class litigation" (slip opinion at 16) because: "First, the switch from bilateral to class arbitration sacrifices the principal advantage of arbitration—its informality—and makes the process slower, more costly, and more likely to generate procedural morass than final judgment." (slip opinion at 14) "Second, class arbitration requires procedural formality . . . If procedures are too informal, absent class members would not be bound by the arbitration." (slip opinion at 15) "Third, class arbitration greatly increases risks to defendants. Informal procedures do of course have a cost: The absence of multilayered review makes it more likely that errors will go uncorrected. Defendants are willing to accept the costs of these errors in arbitration, since their impact is limited to the size of individual disputes, and presumably outweighed by savings from avoiding the courts. But when damages allegedly owed to tens of thousands of potential claimants are aggregated and decided at once, the risk of an error will often become unacceptable." (slip opinion at 15, 16)

goodwill of that business impliedly covenants that he will not solicit the clients of the business. This is known as the *Mohawk* doctrine, and it is based on the reasoning that allowing the solicitation would deprive the buyer of the benefit of the purchase.[14]

Answering a certification request by the Second Circuit[15] about the boundaries of the *Mohawk* doctrine, the New York Court of Appeal concluded that "[w]hile a seller may not contact his former clients directly," he may respond to inquiries from a former client, provide information, and participate in meetings that result from that information. *Bessener Trust Company, N.A. v. Branin, 63* (April 28, 2011).

---

[14] *Mohawk Maintenance Co. v. Kessler, 419 N.E.2d 324 (*1981).

[15] The Second Circuit was deciding a case in which plaintiff, an investment firm, had brought an action against one of its former executives that has previously sold his interest in the firm. Plaintiff alleged a violation of the *Mohawk* doctrine. Defendant alleged that he had not violated the doctrine because he had only passively assisted his new employer after the client had inquiries about where defendant had relocated himself.