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AUTHORS

Thomas E. Gilbertsen
Partner
Commercial Litigation
tegilbertsen@Venable.com
202.344.4598

Michael P. Bracken
Associate
Commercial Litigation
mpbracken@Venable.com
202.344.4179

Judicial Scrutiny of Arbitration Clauses Under *Concepcion*

Two recent federal appellate decisions demonstrate the limits of last year's Supreme Court decision in *AT&T Mobility LLC v. Concepcion*, 131 S.Ct. 1740 (2011). In *Concepcion*, plaintiffs alleged a class of California customers to challenge the wireless carrier's practice of charging sales tax on phones promoted as "free" under various service agreements. When AT&T asserted the arbitration and class waiver provisions in its subscriber agreements, the Southern District of California ruled that the arbitration provision was unconscionable because it contained a class action waiver, and was therefore unenforceable under the rule announced by the California Supreme Court in *Discover Bank v. Superior Court*, 36 Cal.4th 148, 113 P.3d 1100 (Cal. 2005). The Ninth Circuit affirmed on those same grounds. The *Discover Bank* Rule claimed support in § 2 of the Federal Arbitration Act, (9 U.S.C. §2) (FAA) providing certain exceptions to enforcement of arbitration agreements, including "such grounds as exist at law or in equity for the revocation of any contract." Since the FAA's savings clause allows arbitration agreements to be defeated by state law contract defenses, the *Discover Bank* Rule was considered by some to be an appropriate application of traditional unconscionability defenses against class action waivers in arbitration agreements. *Doctor's Associates, Inc. v. Casarotto*, 517 U.S. 681, 687 (1966).

The Supreme Court reversed, holding that *Discover Bank* is preempted by the FAA because any state statute or judicial "rule" purporting to invalidate arbitration agreements stands as an obstacle to the accomplishment and execution of the full purposes and objectives of Congress favoring arbitration by enacting the FAA. The FAA's overarching purpose is to ensure the enforcement of arbitration agreements, under which parties may agree to limit the issues subject to arbitration, or arbitrate according to specific rules, or limit with whom they will arbitrate. But class arbitration, to the extent imposed by rule of court rather than agreement of the parties, is at odds with arbitration's essential function and the FAA's stated policies.

When the *Concepcion* decision was issued in late April 2011, it was widely hailed as a life-altering victory for the class action defense bar – prompting many to declare that arbitration provisions in

consumer contracts and employee handbooks would now insulate merchants and employers from class action litigation. But in the early going, *Concepcion's* impact has been more incremental. To be sure, many courts have invoked *Concepcion* to compel arbitration and stay putative class action. But two recent federal appeals court decisions demonstrate how arbitration provisions in consumer agreements and employment policies still trigger judicial scrutiny when interposed to defeat operation of class action rules.

In *In re American Express Merchants' Litigation*, 2012 WL 284518 (2d Cir. February 1, 2012), merchants who accept American Express cards brought suit in the Southern District of New York pursuing class action antitrust claims. AmEx moved to compel arbitration pursuant to the terms of its agreements with the merchants, which contained a provision allowing either party to elect arbitration and, if arbitration was chosen, precluding class action litigation and the arbitration of on any claims on an aggregated basis. In an earlier opinion, the Second Circuit concluded that it would be prohibitively expensive for the class action merchant plaintiffs to bring individual claims since it would be necessary for them to develop expert testimony at a cost exponentially more than potential individual recoveries (expert fees that could not be recovered under the Sherman Act even if the merchant prevailed in an individual arbitration).

Therefore, the Second Circuit ruled that the class action waiver in the arbitration agreement was unenforceable because it precluded the merchants from vindicating their federal statutory rights. The U.S. Supreme Court had vacated the Second Circuit's original opinion and remanded for reconsideration in light of its 2010 decision in *Stolt-Nielsen, S.A. v. Animal Feeds, Int'l, Corp.* which held that "a party may not be compelled under the FAA to submit to class arbitration unless there is a contractual basis for concluding that the party *agreed* to do so." *Stolt-Nielsen, S.A. v. Animal Feeds, Int'l, Corp.*, 130 S.Ct. 1758, 1775 (2010). On remand, the Second Circuit adhered to its decision that the class action waiver was unenforceable but, before the appellate mandate was issued, the Supreme Court issued its decision in *Concepcion*.

Distinguishing *Concepcion*, the Second Circuit adhered to its previous two decisions that the AmEx class action waiver is unenforceable, concluding that neither *Stolt-Nielsen* nor *Concepcion* render class action arbitration waivers *per se* enforceable and that neither of those cases foreclosed the issue presented:

> "whether a class-action arbitration waiver clause is enforceable even if the plaintiffs are able to demonstrate that the practical effect of enforcement would be to preclude their ability to vindicate their federal statutory rights." *In re American Express Merchants' Litigation*, 2012 WL 284518 at *7.

The Second Circuit concluded that in this case, the class-action arbitration waiver clause was unenforceable because it impinged upon the practical enforcement of other federal statutory rights. The Second Circuit remanded with instructions to deny the

defendant's motion to compel arbitration. By resting upon the practical implications of making individual arbitration of antitrust claims difficult to pursue, the Second Circuit's reasoning appears to go beyond, or even around, the FAA Section 2 and unconscionability defenses to arbitration. We are watching this case for further *en banc* petitioning.

In another recent putative class action, *Carey v. 24 Hour Fitness, USA, Inc.*, 2012 WL 205851 (5th Cir. January 25, 2012), a former sales rep of 24 Hour Fitness, USA, Inc. ("24 Hour") filed suit in the Southern District of Texas after his employment terminated, alleging that 24 Hour violated the Fair Labor Standards Act ("FLSA") by failing to adequately compensate him and other similarly situated employees for overtime work. 24 Hour moved the district court to stay proceedings and compel arbitration of Carey's claim per provisions in defendant's employee handbook which directed that employment-related disputes would be "resolved only by an arbitrator through final and binding arbitration." The handbook further specified that FLSA disputes were among those subject to mandatory arbitration and provided that disputes cannot be brought as class actions. Carey signed a form acknowledging that he had received the employee handbook (the "Acknowledgment"). Importantly, the Acknowledgment contained a provision stating that 24 Hour had the right to "revise, delete, and add to the employee handbook," and any revisions to the handbook "will be communicated through official written notice."

Carey argued and the Fifth Circuit agreed that the arbitration agreement was illusory because 24 Hour retained the right to unilaterally amend the agreement at any time and it could even do so retroactively, eliminating the arbitration requirement after a dispute arose. Specifically the Court held that:

> "where one party to an arbitration agreement seeks to invoke arbitration to settle a dispute, if the other party can suddenly change the terms of the agreement to avoid arbitration, then the agreement was illusory from the outset. The crux of this issue is whether 24 Hour Fitness has the power to make changes to its arbitration policy that have retroactive effect, meaning changes to the policy that would strip the right of arbitration from an employee who has already attempted to invoke it." *Carey v. 24 Hour Fitness, USA, Inc.*, 2012 WL 205851 at *2.

The Fifth Circuit ruled that the employee handbook's silence about the possible retroactive application of amendments to the arbitration policy allowed amendments to apply retroactively. Therefore, the arbitration policy was deemed illusory under Texas law and unenforceable in light of 24 Hour's unilateral ability to avoid its promise to arbitrate even as to claims that were already in progress. The Fifth Circuit confirmed the district court's ruling that 24 Hour could not compel arbitration to go forward.

The take-away from these recent appellate decisions is this: *Concepcion* is no mere talisman for defeating class actions with an arbitration provision. The public policies undergirding the FAA may collide with the Congressional purposes of other statutory

regimes, and state law unconscionability – procedural or substantive – may still arise in a variety of individual circumstances to defeat a consumer contract's arbitration provision. The *Concepcion* decision itself begins with extended emphasis on all the ways AT&T Mobility's arbitration provision favored consumers and was fundamentally fair. When it comes to crafting, amending or litigating an arbitration provision in a consumer contract, that comparison is as good a place as any to start.

Venable office locations

BALTIMORE, MD
750 E. PRATT STREET
SUITE 900
BALTIMORE, MD 21201
t 410.244.7400
f 410.244.7742

LOS ANGELES, CA
2049 CENTURY PARK EAST
SUITE 2100
LOS ANGELES, CA 90067
t 310.229.9900
f 310.229.9901

NEW YORK, NY
ROCKEFELLER CENTER
1270 AVENUE OF THE
AMERICAS
25TH FLOOR
NEW YORK, NY 10020
t 212.307.5500
f 212.307.5598

ROCKVILLE, MD
ONE CHURCH STREET
FIFTH FLOOR
ROCKVILLE, MD 20850
t 301.217.5600
f 301.217.5617

TOWSON, MD
210 W. PENNSYLVANIA AVE.
SUITE 500
TOWSON, MD 21204
t 410.494.6200
f 410.821.0147

TYSONS CORNER, VA
8010 TOWERS CRESCENT DRIVE
SUITE 300
VIENNA, VA 22182
t 703.760.1600
f 703.821.8949

WASHINGTON, DC
575 7TH STREET NW
WASHINGTON, DC 20004
t 202.344.4000
f 202.344.8300