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Supreme Court Finds the *Discover Bank* Rule Preempted by FAA

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INTRODUCTION

Yesterday, in *AT&T Mobility LLC v. Concepcion*, No. 09-893, the Supreme Court abrogated the substantial line of case law that had refused to enforce class action arbitration waivers contained in a variety of consumer contracts, holding that the Federal Arbitration Act preempts any state law that requires the availability of classwide arbitration.

BACKGROUND

The Concepcions sued AT&T in California federal court, alleging that the company engaged in fraud by offering a "free" phone when, in fact, AT&T charged the plaintiffs sales tax on the retail value of the phone. Approximately $30.22 was at stake. The district court consolidated the Conceptions' case with a putative class action involving the same issues.

Each plaintiff in the class entered into separate but identical wireless service agreements with AT&T. Each agreement included: (1) an arbitration clause, requiring any disputes to be submitted to arbitration; and (2) a class action waiver, requiring any dispute between the parties to be brought in an individual capacity and not on behalf of a class. In December 2006, AT&T revised the agreements to add several pro-consumer features, including a "new premium payment clause" designed to incentivize customers to pursue small-value claims.

AT&T moved to compel Plaintiffs to submit their claims to individual, bilateral arbitration. To avoid bilateral arbitration, Plaintiffs argued that the class action waiver was unconscionable under the rule announced by the California Supreme Court in *Discover Bank v. Sup. Ct.*, 113 P.3d 1100 (Cal. 2005). *Discover Bank* held: "[W]hen [a class-action] waiver is found in a consumer contract of adhesion in a setting in which disputes between the contracting parties predictably involve small amounts of damages, and when it is alleged that the party with the superior bargaining power has carried out a scheme to deliberately cheat large numbers of consumers out of individually small sums of money, then . . . the waiver becomes in practice the exemption of the party 'from responsibility for [its] own fraud, or willful injury to the person or property of another'" and therefore "such waivers are unconscionable." AT&T, however, maintained that the *Discover Bank* rule was preempted by the FAA, and also inapplicable because the new premium payment clause eliminated any unconscionability concerns.

The district court found that "a reasonable person may well prefer" the process established by AT&T over class action litigation: customers were "virtually guaranteed" payment of small claims and there was "substantial inducement" to pursue those claims. But notwithstanding individual customer preferences, the court explained, California law requires class relief to deter wrongdoing *generally*.

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On appeal, the United States Court of Appeals for the Ninth Circuit affirmed the district court's interpretation of California law on the ground that customers did *not* have any incentive to pursue small claims despite the new premium payment clause. Once a customer filed for arbitration, the court reasoned, AT&T would simply offer to pay the face value of the claim before the selection of an arbitrator. The Ninth Circuit also noted that unconscionability is a well-established and generally applicable contract defense under state law, and that the *Discover Bank* rule was consistent with the FAA's purpose to place arbitration agreements on the same footing as any other contract.

SUMMARY OF THE DECISION

The Supreme Court, in an opinion written by Justice Scalia and joined by Chief Justice Roberts and Justices Kennedy, Thomas, and Alito, held that the *Discover Bank* rule "interferes with arbitration" and therefore was preempted by the FAA.

The FAA mandates that "courts must place arbitration agreements on an equal footing with other contracts, and enforce them according to their terms." Section 2 of the FAA, the Court acknowledged, allows for arbitration agreements to be invalidated for "'generally applicable contract defenses, such as fraud, duress, or unconscionability,' but not by defenses that apply only to arbitration or that derive their meaning from the fact that an agreement to arbitrate is at issue." The question for the Court, therefore, was whether the FAA preempts the *Discover Bank* rule, under which in recent years most class action waivers in consumer contracts were ruled unconscionable.

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OPINION OF THE COURT

According to the Court, determining whether a state law is displaced by the FAA becomes "more complex when a doctrine normally thought to be generally applicable, such as duress or, as relevant here, unconscionability, is alleged to have been applied in a fashion that disfavors arbitration." The Court agreed with the Concepcions' concession that state law rules, for example, requiring that consumer arbitration agreements provide for judicially monitored discovery, or for the adoption of the Federal Rules of Evidence, would have a disfavoring effect on arbitration and therefore would be preempted by the FAA. But the Court also found the *Discover Bank* rule akin to these more obvious situations, and therefore held: "Requiring the availability of classwide arbitration interferes with fundamental attributes of arbitration and thus creates a scheme inconsistent with the FAA."

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The Court reasoned that, under the FAA, "parties may agree to limit the issues subject to arbitration, to arbitrate according to specific rules, and to limit *with whom* a party will arbitrate its disputes." The informality of arbitration, according to the Court, has the desired effect of reducing costs and increasing the speed of dispute resolution. Rejecting the dissent's contrary position, the Court stated: "[O]ur cases place it beyond dispute that the FAA was designed to promote arbitration."

According to the Court, "[a]lthough the rule does not *require* classwide arbitration, it allows any party to a consumer contract to demand it *ex post*." "The conclusion follows that class arbitration, to the extent it is manufactured by *Discover Bank* rather than consensual, is inconsistent with the FAA." In support, the Court observed: (1) the switch from bilateral to class arbitration will result in sacrificing arbitration's principal advantage of efficiency; (2) procedural formality is required in class arbitration; and (3) class arbitration results in greater risks for defendants. On the last point, the Court noted that "[a]rbitration is poorly suited to the higher states of class litigation" because the

review of arbitral awards "focuses on misconduct rather than mistake."

Finally, responding to the dissent's "claims that class proceedings are necessary to prosecute small-dollar claims that might otherwise slip through the legal system," the Court explained that, even if desirable for other reasons, "States cannot require a procedure that is inconsistent with the FAA . . . ."

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OPINION OF THE COURT

The dissent, written by Justice Breyer and joined by Justices Ginsburg, Sotomayor, and Kagan, stated: "[T]he Court is wrong to hold that the [FAA] pre-empts the rule of state law." First, the dissent maintained: "The *Discover Bank* rule does not create a 'blanket policy in California against class action waivers in the consumer context,'" and that courts applying the rule have enforced class-action waivers when appropriate. Second, the dissent observed that the *Discover Bank* rule is consistent with the FAA because it "applies equally to class action litigation waivers in contracts without arbitration agreements as it does to class arbitration waivers in contracts with such agreements." And third, "[t]he *Discover Bank* rule is also consistent with the basic purpose behind the Act." The dissent warned: "[W]e should think more than twice before invalidating a state law that does just what §2 requires, namely, puts agreements to arbitrate and agreements to litigate 'upon the same footing.'"

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JUSTICE BREYER, DISSENTING

The dissent disagreed with the Court's view "that the *Discover Bank* rule increases the complexity of arbitration procedures, thereby discouraging parties from entering into arbitration agreements and to that extent discriminating in practice against arbitration." The dissent explained: (1) "class arbitration is consistent with the use of arbitration"; (2) the Court incorrectly "compares the complexity of class arbitration with that of bilateral arbitration"; and (3) California's "common law is of no federal concern so long as the State does not adopt a special rule that disfavors arbitration."

Justice Thomas wrote a separate opinion concurring in judgment. Noting that he still adhered to his views on purposes-and-objectives preemption, Justice Thomas "reluctantly" joined the Court's opinion because "it is important in interpreting statutes to give lower courts guidance from a majority of the Court." As Justice Thomas reads the statute, "the FAA requires that an agreement to arbitrate be enforced unless a party successfully challenges the formation of the arbitration agreement, such as by proving fraud or duress." Because the *Discover Bank* rule does not concern the making of an arbitration agreement, the FAA requires that the arbitration agreement be enforced.

IMPLICATIONS

In *Concepcion*, the Supreme Court has taken the final step in a series of decisions concerning class arbitration. In *Green Tree Financial Corp v. Bazzle*, 539 U.S. 444 (2003), the Court found that class arbitration is permissible if parties agree to class arbitration. In *Stolt-Nielsen SA v. AnimalFeeds Int'l Corp.*, 130 S. Ct. 1758 (2010), the Court held that class arbitration is impermissible unless parties affirmatively authorize class arbitration, and that silence on the issue is insufficient. The Court has now held in *Concepcion* that an arbitration agreement precluding class arbitration is indeed valid, and that a state law finding such arbitration agreement to be unconscionable was preempted by the FAA. Given that the contractual waiver at issue also barred consumer participation in a court class action, the FAA preemption announced by the Court should apply equally to and require enforcement of class action waivers contained in arbitration agreements that extend both to arbitration and litigation classes. It remains to be seen whether, in

practice, the Supreme Court's holdings in *Stolt-Nielsen* and *Concepcion* sound a death-knell for class action arbitration in the United States.

For further information about this decision, please feel free to contact members of the Firm's Litigation Department, including:

New York City:

Andy Amer
212-455-2953
aamer@stblaw.com

Mary Beth Forshaw
212-455-7039
mforshaw@stblaw.com

Joseph M. McLaughlin
212-455-3242
jmclaughlin@stblaw.com

Barry Ostrager
212-455-2655
bostrager@stblaw.com

Robert Smit
212-455-7325
rsmit@stblaw.com

Mary Kay Vyskocil
212-455-3093
mvyskocil@stblaw.com

Washington DC:

Peter Thomas
202-636-5535
pthomas@stblaw.com

London:

Tyler Robinson
011-44-20-7275-6118
trobinson@stblaw.com

UNITED STATES

New York
425 Lexington Avenue
New York, NY 10017
+1-212-455-2000

Los Angeles
1999 Avenue of the Stars
Los Angeles, CA 90067
+1-310-407-7500

Palo Alto
2550 Hanover Street
Palo Alto, CA 94304
+1-650-251-5000

Washington, D.C.
1155 F Street, N.W.
Washington, D.C. 20004
+1-202-636-5500

EUROPE

London
CityPoint
One Ropemaker Street
London EC2Y 9HU
England
+44-(0)20-7275-6500

ASIA

Beijing
3119 China World Office 1
1 Jianguomenwai Avenue
Beijing 100004
China
+86-10-5965-2999

Hong Kong
ICBC Tower
3 Garden Road, Central
Hong Kong
+852-2514-7600

Tokyo
Ark Mori Building
12-32, Akasaka 1-Chome
Minato-Ku, Tokyo 107-6037
Japan
+81-3-5562-6200

SOUTH AMERICA

São Paulo
Av. Presidente Juscelino Kubitschek, 1455
São Paulo, SP 04543-011
Brazil
+55-11-3546-1000