JONES DAY

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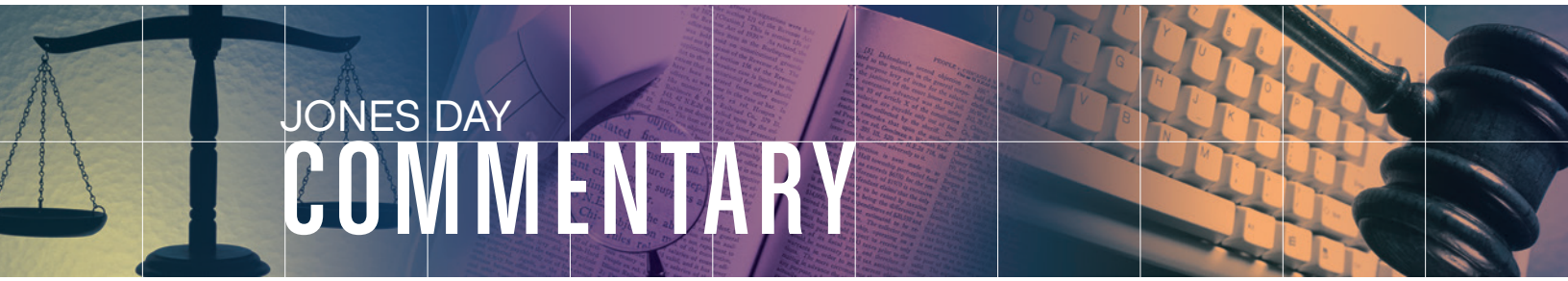

CALIFORNIA SUPREME COURT RECOGNIZES *CONCEPCION* REQUIRES REVERSAL OF *SONIC-CALABASAS* BUT CONTINUES TO DISPLAY SKEPTICISM TOWARD ARBITRATION

On October 17, 2013, the California Supreme Court issued its second decision in *Sonic-Calabasas v. Moreno*. In *Sonic I*, the court ruled that an arbitration agreement's waiver of an administrative hearing on wage claims was void and unenforceable. In *Sonic II*, the court reversed its prior decision, holding that the Federal Arbitration Act ("FAA") preempted any rule categorically prohibiting arbitration agreements that include waiver of administrative hearings. However, the court reaffirmed that traditional defenses to contracts, such as unconscionability, may still be used to prevent enforcement of an arbitration agreement.

In 2011, the California Supreme Court held in *Sonic-Calabasas v. Moreno*, 51 Cal. 4th 659, 671-72 (2011), that an employer could not use a binding arbitration agreement signed by an employee as a condition of employment to avoid the employee's right to invoke an administrative procedure, known as a Berman-hearing, to make a wage claim against her employer. The court held that "requiring" the employee to waive the Berman-hearing violated public policy and was unconscionable.

In so ruling, the court rejected the arguments of the employer that refusing to enforce the arbitration clause violated the FAA. The FAA provides that arbitration clauses are "valid, irrevocable, and enforceable, save upon such grounds as exist at law or in equity for the revocation of any contract." 9 U.S.C § 2. The California Supreme Court acknowledged that the U.S. Supreme Court has made clear that the FAA's "Saving Clause" cannot be used to discriminate against arbitration agreements. *Id.* at 688 (citing *Perry v. Thomas*, 482 U.S. 483, 492-93 (1987). Nonetheless, the California Supreme Court concluded that its invalidation of the Berman-hearing waiver did not discriminate against arbitration agreements because its prohibition applied to all such waivers, whether included in an arbitration agreement or some other agreement. *Id.* at 688-89.

Upon review, the U.S. Supreme Court vacated the California Supreme Court's judgment and remanded the case for reconsideration in light of the U.S. Supreme Court's decision in *AT&T Mobility LLC v. Concepcion*, 131 S. Ct. 1740 (2011). In *Concepcion*, plaintiffs challenged an arbitration agreement that required all disputes to be brought on an individual basis and prohibited the formation of any class for purposes of resolving disputes. The district court held that under California law, a waiver of class arbitration was unconscionable and therefore unenforceable. The U.S. Supreme Court reversed.

The U.S. Supreme Court began by holding that the general purpose of the FAA was to promote efficient, streamlined procedures for resolving disputes. *Concepcion*, 131 S. Ct. at 1749. The Court recognized that in order to accomplish this purpose, federal law has developed a preference for enforcing arbitration agreements according to their terms. *Id*. at 1745-46. Consistent with this preference, the Court noted that while the FAA's Savings Clause preserves generally applicable contract defenses against unfair arbitration agreements, "nothing in [the Saving Clause] suggests an intent to preserve state-law rules that stand as an obstacle to the accomplishment of the FAA's objectives." *Id*. at 1748. In other words, when a state law rule purportedly based on traditional contract defenses such as fraud, duress, or unconscionability stands as an obstacle to the accomplishment of the FAA's objectives, the FAA may preempt and displace such a rule. Applying this standard, the Court held that California's rule prohibiting collective-arbitration waivers as unconscionable was preempted by the FAA because the rule stood as an obstacle to the FAA's objectives of efficient, streamlined procedures. *Id*. at 1753.

On remand, the California Supreme Court first held that *Sonic I* was overruled by *Concepcion*. In particular, the court recognized that a Berman-hearing would delay the arbitration, and prohibiting the waiver of the hearing would thus interfere with the fundamental attribute of arbitration, "namely, its objective to achieve streamlined proceedings and expeditious results." Op. at p. 25-26 (*citing Concepcion*, 131 S.Ct. at 1749). The court distinguished the delay caused by a Berman-hearing from the delay caused by litigating the enforceability of an arbitration agreement. The court stated, "the parties to a contract must have an opportunity to determine whether the arbitration agreement should be enforced…. But it does not follow that the FAA, as interpreted by *Concepcion*, permits additional delay that results not from adjudicating whether there is an enforceable agreement, but from an administrative scheme to effectuate state policies unrelated to the agreements' enforceability." Op. at p. 27.

Despite having acknowledged the purpose of the FAA and the dictates of *Concepcion*, the California Supreme Court's apparent eagerness to permit litigants to assert reflexive unconscionability defenses whenever faced with motions to compel arbitration stands in stark contrast to the recent prevailing dictates from the U.S. Supreme Court. The *Sonic II* base holding that the plaintiff should have the opportunity to demonstrate that the mandatory arbitration clause and waiver of the Berman-hearing is unconscionable under the circumstances is not, in a vacuum, surprising; even the U.S. Supreme Court has recognized that the FAA's Savings Clause allows parties to rely on defenses such as unconscionability to prevent the enforcement of an arbitration agreement. *Concepcion*, 131 S.Ct. at 1748. But the California Supreme Court did not articulate a clear standard for what would constitute unconscionability, especially considering that "forcing" a party to abide by an arbitration provision to which it agreed is precisely what the FAA was intended to protect.

In concurring opinions, Justices Corrigan and Chin criticized the majority for not clearly providing a sufficiently rigorous standard for invoking the unconscionability defense. They argued that the proper test should be "whether the terms are so one-sided as to shock the conscience." Conc. Op. of Justice Corrigan at p. 1 (internal citations omitted); Conc. and Dis. Op. of Chin, at p. 7-8. The majority's explanation of the unconscionability test was much more equivocal, focusing on "whether the arbitral scheme imposes costs and risks on a wage claimant that make the resolution of the wage dispute inaccessible and unaffordable…." Op. at p. 35.

This last conclusion—that the arbitration agreement may be unconscionable if it fails to provide an affordable venue to resolve a wage claim—seemingly contradicts the recent U.S. Supreme Court decision *American Express Co. v. Italian Colors Restaurant*, 133 S.Ct. 2304 (2013). In *Italian Colors*, the Supreme Court held that waiver of class arbitration was nonetheless valid even if the cost of arbitrating individuals

claims so outweighed potential recovery such that relief was elusive and unaffordable. The Court explained that parties are not guaranteed the "right to pursue" the antitrust remedy at issue in "an affordable procedural path to the vindication of every claim." *Italian Colors*, 133 S.Ct. at 2309. The *Sonic II* court distinguished *Italian Colors* in two ways: (i) *Italian Colors* examined the "effective vindication" doctrine that deals with the harmonization of federal statutes, whereas the issue in *Sonic-Calabsas* is preemption; and (ii) unlike the antitrust statute in *Italian Colors*, which did not guarantee efficient and affordable resolution of a claim, the Berman-hearing was a legislative guarantee to effective and cost-efficient resolution of an employee's wage claims. Op. at pp. 44-50 ("Whereas the class waiver in *Italian Colors* eliminated no statutory entitlement specifically designed to help vindicate the rights at issue there, the same is not true of the waiver of statutorily provided Berman protections in this case.").

The practical effect of the majority's holding (unless the U.S. Supreme Court grants review again) is unclear. On the one hand, its holding that a court should consider whether the arbitration provides a cost-effective means of litigating a wage claim is limited to this specific situation, whether the California Legislature enacted a specific procedural law to provide inexpensive means of litigating a wage claim. This is particularly true because the court distinguished *Italian Colors* by relying on the specific nature of the Berman-hearing statutes. To that end, the holding could be very limited.

On the other hand, the Ninth Circuit Court of Appeal's recent decision in *Chavarria v. Ralph's Grocery Co.,* -- F. --, Case No. 11-56673 (Oct. 28, 2013), will also help clear the path for challenging arbitration clauses. There, the court held Ralph's arbitration clause was unconscionable because it effectively allowed Ralph's to choose the arbitrators in each case and it forced the employees to pay half the arbitration costs. The court distinguished *Italian Colors* because there the plaintiff complained that the costs of individual arbitration—as a result of the class arbitration waiver—far outweighed the potential relief, rendering relief illusory. In contrast, in *Chavarria*, the arbitration fees themselves made relief illusory.

The lesson for businesses is to carefully craft their arbitration clauses and to not overreach. Indeed, businesses can be certain that parties opposing arbitration will rely on *Sonic II* to argue that the agreement is "unreasonably one sided" and therefore unconscionable. As Justice Chin noted in his concurring and dissenting opinion, this can easily lead to mini-trials of whether the arbitration agreement is enforceable. As some small consolation, though, parties can enter into arbitration agreements that require the arbitrator to make the initial determination of whether the agreement is unconscionable. *See*, e.g., *Fallo v. High-Tech Inst.,* 559 F.3d 874, 880 (8th Cir. 2009) (holding unconscionability argument directed at the arbitration provision itself had to be decided by arbitrator because parties incorporated AAA rules). And given the intricacies in the interplay between federal and state law as well as the shifting sands in judicial opinions, it will be prudent for companies to obtain legal advice when drafting any arbitration clause.

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