When Are Arbitration Agreements Preempted by the FAA?

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Decisions of the U.S. Supreme Court in recent years have discouraged many parties from seeking to invalidate arbitration agreements on the ground that they are unconscionable under state law.

Thus, in *AT&T Mobility LLC v. Concepcion*, 131 S. Ct. 1740 (2011), the Supreme Court held that California's rule making class action waivers unconscionable was preempted by the Federal Arbitration Act (FAA).

In 2013, the Supreme Court reinforced that concept in *American Express v. Italian Colors Restaurant*, 133 S. Ct. 2304 (2013), holding that the class action waiver in an arbitration agreement was binding, notwithstanding that this may have effectively foreclosed parties from seeking to enforce claims under the Sherman Antitrust Act. Although recognizing that an individual plaintiff seeking to pursue these claims would be required to expend hundreds of thousands of dollars with an individual recovery limited to $40,000, the class action waiver provision was not deemed to "constitute an elimination of the right to pursue that remedy" even though, for all practical purposes, it did.

Nonetheless, federal courts have continued to invalidate arbitration agreements where the court has determined that they contain unconscionable provisions under state law and to refuse to find their preemption by the FAA.

A most recent example in this regard is found in a decision of the U.S. Court of Appeals for the Ninth Circuit, *Chavarria v. Ralphs Grocery*, (11-56673, 10/28/13).

In *Chavarria*, the plaintiff, who had been employed by Ralphs for six months, sued alleging violations of the California Labor Code. Ralphs moved to compel arbitration based upon an arbitration agreement that was incorporated into each employment application. The application included the applicant's acknowledgement that the arbitration policy (although not part of the application) had been provided for the applicant's review, and that the applicant agreed to be bound by its provisions.

The district court denied arbitration on the ground that the agreement was unconscionable under state law, and that in the circumstances of this case, the FAA did not preempt the state rule. The court rejected Ralphs' argument that the FAA preempts any state law restriction on arbitration agreements and that such agreements must be enforced in accordance with their provisions.

The Ninth Circuit agreed with the district court holding that arbitration agreements do not differ from any other contracts and can be invalidated under state law for fraud, duress or unconscionability. In fact, the FAA provides that arbitration agreements must be enforced "save upon such grounds as exist at law or in equity for the revocation of any contract." Accordingly, a state determination of unconscionability will not be preempted by the FAA if the state rule applies to contracts generally and does not impact arbitration agreements disproportionately. "The U.S. Supreme Court has held that the state rules disproportionately impacting arbitration, though generally applicable to contracts of all types, are nonetheless preempted by the FAA when the rule stands as an obstacle to the accomplishment of

Congress' objectives in enacting the FAA." Otherwise, "Arbitration agreements … must be placed on equal footing with other contracts."

In *Chavarria*, the court found that the unconscionable provisions in the agreements applied to contracts generally and did not impact arbitration agreements disproportionately. Moreover, the court held that while the arbitration agreement in this case did not eliminate the right to pursue the arbitration remedy (which ordinarily might trigger preemption), the cost that the employer's arbitration agreement imposed on employees seeking to bring such claims might be considered.

The court found that both procedural and substantive unconscionability are required to invalidate an arbitration agreement under California law.

The court explained that procedural unconscionability "concerns the manner in which the contract was negotiated and the respective circumstances of the parties at the time, focusing on the level of oppression and surprise involved in the agreement."

In this case the arbitration policy was presented to the prospective employee, Zenia Chavarria, on a "take it or leave it" basis with no opportunity for the employee to negotiate its terms. Moreover, the terms of the arbitration policy were not provided to the employee until three weeks after she had agreed to be bound by it.

Ralphs suggested that the prospective employee was not required to agree to the terms to be hired. It highlighted language in the application that only asked the employee to sign, as it stated, "please sign."

The court rejected this argument because the "terms of the policy itself" bound the employee "regardless of whether she signed the application." Moreover, the court was not impressed by the softer language in the application, stating, "That Ralphs asked nicely for a signature is irrelevant. The policy bound Chavarria and all other potential employees upon submission of their applications."

The court further found that the procedural unconscionability was "enhanced" because she was provided the terms of the agreement only three weeks later during her employee orientation.

The court also found substantive unconscionability in that the contract is unjustifiably one-sided to such an extent that it "shocks the conscience."

The court found that Ralphs' arbitrator selection process would inevitably produce an arbitrator proposed by Ralphs in employee-initiated arbitration proceedings. The procedure provided that if the parties could not agree on an arbitrator, each party would propose a list of three arbitrators, and engage in alternating strikes with the party making the demand for arbitration striking first. In practice this would mean that one of the three arbitrators designated by the party that had not demanded arbitration would serve as the arbitrator. In virtually all circumstances, that would be Ralphs.

Moreover, even if there were a limited number of cases that might disadvantage Ralphs, this is "no consolation to the individual employee who is disadvantaged in her one and only claim. Forcing her into an arbitration process where Ralphs has an advantage could not be justified on the possibility that some other employee might someday get the upper hand in that employee's arbitration against Ralphs." In short, "the selection process is not one designed to produce a true neutral in any individual case."

The court also found unconscionable that the system required the arbitrator to apportion the costs equally between Ralphs and the employee, disregarding potential state law that contradicts this allocation. The court distinguished other cases where it had upheld such provisions where the risk that the plaintiff might face prohibitive costs was speculative. Here, however, there is nothing speculative about the costs; these provisions "impose significant costs on the employee upfront, regardless of the merits of the employee's claims, and severely limits the authority of the arbitrator to allocate arbitration costs in the award."

In summary, a general impression exists that it is virtually impossible to object to an arbitration agreement imposed by an employer or a company with which one does business. In fact, federal courts are not loathe to invalidate arbitration agreements that are unconscionable under state law as they would any contract, unless these laws impact the arbitration agreement disproportionately. (For example, the Sixth Circuit opinion in *Day v. Fortune Hi-Tech Marketing*, No 12-6304, 9/12/13, which found the arbitration clause unenforceable as not supported by adequate consideration: "Because the defendant retained the ability to modify any term of the contract at any time, its promises were illusory.")

The message for those proposing to include mandatory arbitration provisions in their agreements, particularly those imposed upon employees, is clear. Care must be taken to ensure that they are deemed fair and not unconscionable under state law. The FAA will not preempt unconscionable provisions that would require the revocation of any contract generally.

In short, do not assume that anything goes in an arbitration agreement, because it does not.

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