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The U.S. Supreme Court and Class Arbitration: A Tragedy of Errors

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This post addresses the U.S. Supreme Court's misadventures with class arbitration over the past decade. Those misadventures have resulted in striking confusion and waste of resources by litigants, courts and arbitral institutions. More broadly, the Court's conflicting and often ill-considered decisions on the subject now threaten to undermine U.S. arbitration law more generally – turning a field where U.S. courts once pioneered international developments, in decisions like *Mitsubishi* and *Scherk*, into one where the U.S. Supreme Court's decisions stand out as examples of how not to deal with the arbitral process.

U.S.-style class actions are by now familiar, if only by reputation, in many international quarters. Under the U.S. litigation system, a class action is a civil suit, often a mass torts or consumer litigation, in which one or more named plaintiffs represent a large, sometimes indeterminate, number of similarly-situated individuals in pursuing related claims against one or more defendants. The logic of class actions is to permit large numbers of comparatively small claims, which would otherwise not readily be pursued, to be heard efficiently in a single proceeding. The class action system is, to be sure, beset by many flaws and challenges, but it is also one that has attracted, and continues to attract, substantial interest and following in non-U.S. legal systems.

Over the past two decades, the use of class action procedures migrated from litigation to arbitration in domestic U.S. practice. State courts, notably in California, paved the way in permitting arbitrations to be conducted on a class basis, on behalf of large numbers of similarly-situated claimants (usually consumers), all having identical arbitration agreements with the same defendant. For a time, class arbitration was, in the words of one commentator, a "mythical beast: half litigation, half arbitration and rarely seen." After the U.S. Supreme Court's decision in *Green Tree Financial Corp. v. Bazzle*, 539 U.S. 444 (2003), however, class arbitration sightings became frequent in U.S. practice. Indeed, according to recent reports, the American Arbitration Association (AAA) is currently administering nearly 300 class arbitrations.

In *Bazzle*, a plurality decision of the Supreme Court considered whether or not class action claims could be pursued in arbitration and concluded that arbitrators, not courts, must determine in the first instance "whether [an] arbitration contract[] forbid[s] class arbitration"; moreover, consistent with its analysis in First Options and similar decisions on arbitrators' competence-competence, the *Bazzle* plurality also declared that arbitral decisions about the availability of class arbitration were subject to only minimal judicial review. At the same time, *Bazzle* also indicated that class arbitration could be available even when the arbitration agreement was silent on the issue (with

class arbitration impliedly contemplated by the parties). Needless to say, *Bazzle* rested on the premise that class arbitration was compatible with the FAA (otherwise, there would have been no basis for permitting arbitral tribunals to order class arbitrations) and that class arbitration agreements were fully enforceable under sections 2 and 4 of the FAA.

The Court's decision in *Bazzle* created the platform for arbitral tribunals to permit class arbitrations – a possibility which, in practice, tribunals not infrequently permitted. At the same time, in the wake of *Bazzle*, both the AAA and JAMS issued rules for the administration of class arbitration. And, as noted above, arbitral tribunals not infrequently found that parties had agreed to class arbitration, particularly in cases involving consumer contracts – resulting in a significant caseload of more than 300 pending class arbitrations by 2011.

In a related development, some state courts ruled that provisions in arbitration agreements waiving the right to arbitrate on a class-wide basis were, in certain circumstances, unconscionable as a matter of state law and therefore unenforceable. That development contributed to the increase in class arbitrations, by restricting the ability of parties contractually to exclude the possibility of class arbitration.

The Supreme Court's approach to class arbitration shifted dramatically in *Stolt-Nielsen S.A. v. AnimalFeeds Int'l Corp*., 130 S.Ct. 1758 (2010). Notwithstanding its earlier decision in *Bazzle* – that the availability of class arbitration was for arbitrators to decide, subject to only minimal judicial review – the Court's *Stolt-Nielsen* decision overturned an arbitral tribunal's finding that class arbitration was impliedly permitted by the parties' agreement. The Court held that the arbitrators' decision that class arbitration was permitted was based on supposed policy considerations, and not the parties' agreement. The Court also held that "class-action arbitration changes the nature of arbitration to such a degree that it cannot be presumed that the parties consented to it by simply agreeing to submit their dispute to an arbitrator." The *Stolt-Nielsen* Court appeared to require an express agreement to class arbitration and, if not, a relatively clear affirmative showing of an implied agreement to class arbitration: only when "the parties agreed to authorize class arbitration" could arbitrators find that class arbitration was available. The Court's *Stolt-Nielsen* decision not only reversed its earlier decision, in *Bazzle*, that questions whether the parties had consented to class arbitration should be decided by the arbitrators, but also adopted a fundamentally different, and more hostile, approach to the question whether or not an arbitration agreement in fact permitted class arbitration.

In late April of this year, less than ten years after its decision in *Bazzle* ushered in class arbitration in the United States, the Supreme Court appears to have come nearly full circle and very substantially limited the future of class arbitrations. The Court's decision came in *AT&T Mobility LLC v. Concepcion*, 131 S.Ct. 1740 (2011), which arose when the Concepcions filed a complaint against AT&T alleging that it had defrauded them by charging sales tax (about $30) on phones advertised as free. The Concepcions' complaint was consolidated with a class action on behalf of other cell phone users, and AT&T sought dismissal of the litigation; it moved to compel individual arbitration as provided by an arbitration clause contained in the cell phone contracts of the Concepcions and other AT&T customers. Those arbitration clauses required arbitration of all disputes between AT&T and each of its customers, while also containing a class action waiver that provided that all claims be brought in the parties' "individual capacity, and not as a plaintiff or class member in any purported class or representative proceeding." The arbitration clauses also provided (if any doubt remained) that "the arbitrator may not consolidate more than one person's claims, and may not otherwise preside over any form of a representative or class proceeding."

In turn, the Concepcions argued that the class action waiver was unenforceable under the California Supreme Court's decision in *Discover Bank v. Superior Court*, 36 Cal. 4th 148 (2005). *Discover Bank* declared class action waivers unconscionable under California state law when "the waiver is found in a consumer contract of adhesion in a setting in which disputes between the contracting parties predictably involved 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." Applying the *Discover Bank* rule, the District Court and the Ninth Circuit Court of Appeals rejected AT&T's motion to compel individual arbitrations, holding that the class action waiver was unconscionable, and therefore permitting the Concepcion's class action litigation to proceed.

The lower courts were unmoved by the "consumer-friendly" aspects of the arbitration agreement at issue in AT&T's cell phone contracts. Among other things, that agreement provided for arbitration in a convenient situs (where the consumer is billed); arbitration in person, by telephone or online, at the consumer's choice, for amounts less than $10,000; the availability of injunctive relief and punitive damages; no right by AT&T to claim attorneys' fees; and an option to choose small claims court (rather than arbitration). These features did not, however, dissuade the lower courts from invalidating the class action waiver (and the underlying agreement to arbitrate) on unconscionability grounds.

In a 5-4 decision, the Supreme Court reversed. Writing for the majority, Justice Scalia reasoned that California's *Discover Bank* rule disfavors arbitration because it requires class arbitration, which, in his view, is incompatible with the "fundamental" or true historic character of arbitration. Justice Scalia relied on section 2 of the FAA, which makes arbitration agreements "valid, irrevocable and enforceable, save upon such grounds as exist at law or in equity for the revocation of any contract." According to the Court, state law may not require procedures that are "not arbitration as envisioned by the FAA," and "[r]equiring the availability of classwide arbitration interferes with fundamental attributes of arbitration and thus creates a scheme inconsistent with the FAA."

The foundation for the Court's reasoning was its claim that class arbitration was not really arbitration in the sense contemplated by the FAA. The Court opined that "class arbitration requires procedural formality" and then said that "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." The Court also thought that "class arbitration greatly increases risk to defendants" by aggregating claims without providing for multilayered review. Given the limited grounds upon which courts can vacate an arbitral award, arbitration is "poorly suited to the higher stakes of class litigation." Finally, the Court found it significant that class arbitration did not exist in 1925, when the FAA was enacted – apparently suggesting that class arbitration was thus inconsistent with "arbitration as envisioned by the FAA."

The Court concluded that imposing California's prohibition against class action waivers, and the resulting preference for class arbitration, would frustrate the purpose of arbitration as contemplated by the FAA and could result in fewer companies choosing to arbitrate. The Court therefore held that the *Discover Bank* rule "stands as an obstacle to the accomplishment and execution of the full purposes and objectives of Congress" and is preempted by the FAA.

Writing for the dissent, Justice Breyer reasoned that the FAA's purpose is not to promote arbitration, but to treat arbitration on equal footing as other contracts, citing the savings clause of

section 2 of the FAA. Thus, the dissent reasoned that "California is free to define unconscionability as it sees fit.... Because California applies the same legal principles to address the unconscionability of class arbitration waivers as it does to address the unconscionability of any other contractual provision, the merits of class proceedings should not factor into our decision." Justice Breyer also reasoned that "class arbitration is consistent with the use of arbitration," and pointed out that the AAA's amicus brief in *Stolt-Nielsen* "found class arbitration to be 'a fair, balanced and efficient means of resolving class disputes.'" Invoking federalism principles, the dissent concluded that "weighing the pros and cons of all class proceedings" was California's decision to make.

Reading the various opinions in *Bazzle*, *Stolt-Nielsen* and now *Concepcion* makes one wish that the U.S. Supreme Court would stop deciding arbitration cases for a while – preferably, a long while. Preliminarily, the erratic course of ushering in class arbitration in *Bazzle*, followed by largely or entirely ushering it out again a decade later in *Stolt-Nielsen* and *Concepcion*, is both an institutional embarrassment and a profligate waste of resources – What was the point, and why must parties and taxpayers bear the costs, of the countless disputes, arbitrations and litigations over the past ten years provoked by the Court's shifting views? What happens now to the 300 or so AAA class arbitrations which are pending? What weight should parties and lower courts give to future Supreme Court pronouncements on the FAA – and for how long?

Turning to the law, Justice Scalia's opinion is profoundly misconceived and fundamentally misunderstands the arbitral process. Most importantly, Justice Scalia's declarations about the supposed "fundamental" character of arbitration, which is envisioned by the FAA, are both woefully inaccurate and dangerous: indeed, those declarations threaten the broader body of U.S. arbitration law by suggesting that the FAA only protects a particular type of arbitration, being the archetype that, in Justice Scalia's view, was envisioned by Congress in 1925. In fact, contrary to the Court's supposed archetype, arbitration has historically taken widely varying forms, in widely varying settings – ranging from institutional to ad hoc arbitration, from trade, commercial, religious, and international to investor-state arbitration, ranging from documents only, on-line or quality arbitrations to arbitrations resembling trial court litigations.

First, arbitration is by no means necessarily informal – rather, arbitration is aimed first and foremost at ensuring the parties' procedural autonomy. Sometimes that means procedural informality; sometimes it means procedural innovation; and sometimes it means procedural formality. Arbitrations with a high degree of procedural formality are conducted around the United States, and the world, every day – if that is what the parties desire and agree upon. Contrary to the Court's suggestions, there is nothing inherent in arbitration that excludes formality, motions, or complexity.

Second, again contrary to Justice Scalia's views, there is nothing inherent in arbitration that limits it to small stakes. On the contrary, enormous disputes have always been, and still are, decided in arbitration – take, variously, the 19th century Alabama Arbitration (where the United States recovered an amount from the United Kingdom equal to its annual government budget), the IBM/Fujitsu arbitration (involving, in the 1970s, billions of dollars), the 1980's Iran-U.S. Claims Tribunal (which adjudicated many billions of dollars in claims, by both private and government parties), the Andersen Consulting arbitration (with an award in excess of $10 billion), and any one of the dozens of currently pending domestic and international commercial and investment arbitrations, all involving amounts well in excess of $1 billion. Justice Scalia's conception of arbitration as inherently small is flatly wrong.

Third, the Court's suggestion that arbitration is somehow limited to what Congress envisioned in 1925 is equally wrong. Arbitration in the 21st century has no necessary resemblance to that in 1925 – nor should it: arbitration has historically evolved and been tailored to respond to economic, social and technological developments. As a consequence, contemporary arbitration now routinely addresses statutory claims (under legislation enacted decades after 1925), using telecommunications, on-line and other technologies (developed decades after 1925), dealing with commercial businesses and industries that did not exist when the FAA was enacted. Indeed, although the irony was apparently lost on the Court, the arbitration agreement at issue in Concepcion itself provided for on-line consumer arbitration of cell phone disputes involving multiple statutory claims. Justice Scalia's suggestion that the FAA only envisioned a particular kind of informal, small stakes, bipartite arbitration of the sort supposedly conducted in the 1920's is Tea Party originalism run amok – and patently wrong.

Justice Scalia's suggestion that arbitration under the FAA is really only that kind of dispute resolution that existed in 1925 is as dangerous as it is misinformed: taken at face value, the suggestion that the FAA protects only or primarily a particular historical conception of arbitration – involving informal, small bipartite trade disputes – threatens to radically limit the meaning and effect of the FAA. Indeed, the various aspects of Justice Scalia's conception of arbitration are eerily reminiscent of some 19th century judicial decisions, which treated arbitration as a second class form of rough justice suitable only for limited types of disputes and subject to strict judicial supervision. Hopefully, the Court's erroneous conception of arbitration will remain but an historical oddity that does not further confuse the development of arbitration law under the FAA or elsewhere – but the risk that it will have further deleterious consequences, like Justice Story's antipathy for arbitration in the 1800's, is a very real one.

Tragically, the result in *Concepcion* could have been arrived at in a sensible manner, without resurrecting long-dead biases against arbitration or threatening to confuse and limit the protections of the FAA. The *Discover Bank* rule of unconscionability was not, as the dissent concluded, a generally-applicable rule of unconscionability, applicable to all contracts within the meaning of section 2 of the FAA. Rather, the *Discover Bank* rule was tailored for and specifically directed to class action waivers, in arbitration and litigation, and created a special standard of invalidity for such waivers (i.e., class actions waivers were invalid whenever they involved adhesion contracts, multiple small claims and an alleged scheme to defraud consumers). That kind of rule fails the most basic requirement of section 2 – which requires the application of generally-applicable contract law defenses which could apply to "the revocation of any contract." Here, the California rule applied only to a narrow sub-set of contractual provisions – namely, waivers of particular forum selection provisions – and was not, as demanded by section 2, a rule generally applicable to all contracts. As such, the *Discover Bank* rule is preempted by section 2's requirement that arbitration agreements be enforced in accordance with their terms.

More fundamentally, the *Discover Bank* rule is precisely the type of state law invalidation of arbitration agreements that the FAA was intended to prohibit. The *Discover Bank* rule forbids agreements to arbitrate a defined category of disputes (involving specified categories of fraud claims arising from particular types of contract). As applied in *Concepcion*, the *Discover Bank* rule required resolution of these disputes in a different forum from the arbitral forum agreed to by the parties (specifically, in class action litigation – because, as the lower courts in *Concepcion* held, the parties had not agreed to class arbitration and the Concepcion's class action claims therefore had to be pursued in litigation). Thus, this application of the *Discover Bank* prohibition is precisely like typical state law non-arbitrability rules, such as requirements that all state securities law or

franchise disputes be resolved in state courts or before state administrative tribunals; like those requirements, the Discover Bank prohibition is also preempted by section 2.

The fact that the *Discover Bank* rule is characterized as one of "unconscionability" does nothing to alter its substantive character – being to forbid agreements to arbitrate certain categories of disputes and to instead require class litigation – and directly contradicts section 2. Contrary to Justice Breyer's dissent, it is irrelevant that the *Discover Bank* rule forbids class actions waivers in litigation as well as arbitration: it is indisputable that a state law rule requiring that all securities fraud or employment claims be resolved only in a specified state administrative agency, or a particular, specialized state court, would be invalid under section 2 of the FAA – notwithstanding the fact that the state law applied equally to forum selection clauses and arbitration agreements. Similarly, the fact that state law might forbid forum selection agreements choosing an out-of-state forum, in all or specific categories of cases, would not permit application of such rules to arbitration agreements. The fundamental point is that a state law rule which invalidates the parties' agreement to arbitrate, on a basis not applicable equally to all contracts, is preempted by section 2.

Finally, this analysis would be no different if the Ninth Circuit in *Concepcion* had applied the *Discover Bank* rule to require class arbitration, rather than class litigation. The *Discover Bank* rule would still not be a generally-applicable rule of contract law, as requiring by section 2's savings clause, and, on the contrary, would still be a specially-designed rule applicable to limited categories of contracts – particularly, agreements to arbitrate – which is preempted by section 2. As already noted, it is irrelevant that the Discover Bank rule applies to class action waivers in forum selection clauses, as well as arbitration agreements: the decisive point is that the rule is not one that applies generally to all contracts and that instead applies only to the provisions of dispute resolution agreements.

More fundamentally, there is no basis in the FAA for a court to require parties to arbitrate in a manner they never agreed (it being clear that the AT&T arbitration agreement specifically did not provide affirmatively for class arbitration, even under the *Bazzle* standards). Just as section 2 does not permit states to require class litigation of particular categories of disputes, so neither section 2 nor section 4 of the FAA permit states to require class arbitrations that the parties have not accepted, and instead have specifically excluded, in their agreement to arbitrate. This conclusion does not rest on any judgment that class arbitration is not true arbitration or what Congress envisioned in 1925; it rests on the simple conclusion that the *Discover Bank* rule requires parties to arbitrate against parties with whom they have not agreed to arbitrate – a simple and obvious breach of section 2's basic rule of party autonomy.

The same conclusion would apply equally to a state law requirement that all arbitrations be conducted only in a local, in-state seat (regardless what the parties' agreement on arbitral seat provided), that all arbitrations be conducted before a sole arbitrator (regardless what the parties' agreement provided) or that all arbitrations include either broad discovery or an in-person evidentiary hearing (again, regardless what the parties had agreed). In each case, there is nothing in the "fundamental" character of arbitration that is inconsistent with arbitrations being conducted in any particular place, before a sole arbitrator or with discovery or a live evidentiary hearing: arbitrations are conducted in such places, before sole arbitrators and with discovery and live hearings all the time. Rather, in each case, the requirement imposed by state law offends sections 2 and 4 of the FAA because it forces parties to conduct an arbitration in a manner that they have not agreed. Those requirements – like the *Discover Bank* rule requiring parties to arbitrate in a manner to which they have not agreed – violate the FAA's basic rule of party autonomy.

Despite these easy answers to *Concepcion*, the U.S. Supreme Court embarked on unnecessary and ill-informed discourse on the supposedly fundamental or inherent character of the arbitral process. One can only wonder what the Court will say next about arbitration. And, sadly, one can only hope that we will wait a long time to hear.

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