CONSUMER FINANCIAL SERVICES LAW REPORT

FOCUSING ON SIGNIFICANT CASELAW AND EMERGING TRENDS

OCTOBER 23, 2015 | VOLUME 19 | ISSUE 10

GUEST COMMENTARY

CALIFORNIA'S TOP COURT WEIGHS POST-*CONCEPCION* CONSUMER ARBITRATION PROVISIONS

By Hunter R. Eley, Will Edmonson, and Margaret McHugh-Sivore

Hunter R. Eley is managing partner and chair of the financial services litigation team at ***Doll Amir & Eley LLP*** in Los Angeles. ***Will Edmonson*** is a partner in the firm and a member of the financial services litigation team. ***Margaret McHugh-Sivore*** is an associate and member of the financial services team.

The California Supreme Court's recent decision in *Sanchez v. Valencia Holding Co., LLC* signals the definitive word in California on the enforceability of arbitration provisions in consumer contracts. Or does it?

Much anticipation preceeded *Sanchez*. How would the California Supreme Court react to the United States Supreme Court's decision in *AT&T Mobility LLC v. Concepcion*? After all, it was the California Supreme Court's *Discover Bank* rule — a decision that empowered courts to decline to enforce class action waivers in certain arbitration clauses — that the U.S. Supreme Court rejected in *Concepcion*.

Told its application of state law to arbitration clauses was wrong; that California law was preempted by federal law; and that class-action waivers in arbitration agreements are enforceable, practitioners and commentators alike since have been wondering how California's highest court would respond when faced with another decision on whether to enforce an arbitration provision in a consumer contract. Curiosity and speculation grew as the CFPB announced the results of its consumer arbitration study in March and raised visibility of the issue in the public eye.

When the state's High Court granted review in *Sanchez*, it garnered immediate attention because the case had all the right elements. The underlying dispute arose out of a form contract used in the purchase of an automobile. The preprinted form had an arbitration clause on the back of the one-page document. The arbitration clause included a class action-waiver provision. The consumer claimed not to have known about it.

Key decisions in the case straddled *Concepcion*. Prior to *Concepcion*, the trial court refused to enforce the arbitration clause. Post-*Concepcion*, the California Court of Appeal refused to enforce the arbitration clause. The California Supreme Court disagreed with both of them. Hewing to *Concepcion*, the Court held the class waiver provision was enforceable. Furthermore, it reversed the appellate court's finding that other provisions in the arbitration clause were unconscionable.

Favorable as the outcome was to consumer arbitration supporters, the *Sanchez* decision highlights an ongoing tension in post-*Concepcion* jurisprudence. On the one hand, the *Sanchez* Court acknowledges the mandate to enforce class-action waiver provisions in the face of state law prohibitions that are preempted

under the FAA. On the other hand, the Court narrowlyinterprets that mandate and steadfastly preserves courts' role in policing unfairness by applying a state's general contract principles (*e.g.*, unconscionability defenses) to other provisions in the arbitration clause. Yet, a question remains: How will state courts apply the law of unconscionability to other (non-class waiver) arbitral provisions?

SANCHEZ, IN CONTEXT

The significance of *Sanchez* is best understood in the context of the public debate over arbitrations in consumer credit contracts. On March 10, 2015, the CFPB issued its long-awaited arbitration study, a 720-page purportedly "empirical, not evaluative" study of "the use of agreements providing for arbitration of any future dispute … in connection with the offering or providing of consumer financial products or services."[1] Many in the industry view the CFPB's findings as the scaffolding that will be used to erect sweeping regulation designed to limit or prohibit mandatory arbitration provisions in consumer contracts.

Not long after, members of the House and Senate admonished the CFPB to reopen the arbitration study, arguing that its process, which failed to provide the general public with any meaningful opportunities to provide input … has not been "fair, transparent or comprehensive."[2]

Then, in July 2015, the American Bankers Association, the Consumer Bankers Association, and The Financial Services Roundtable formally submitted comments to the CFPB, arguing that analysis "supports a conclusion that pre-dispute arbitration clauses benefit consumers and that those benefits should not be restricted or prohibited."[3]

More recently, on Aug. 3, 2015, Professors Jason Scott Johnston of the University of Virginia School of Law and Todd Zywicki of George Mason University published "The Consumer Financial Protection Bureau's Arbitration Study: A Summary and Critique," in which the authors concluded that, "The CFPB's Report … provides no foundation for imposing new restrictions or prohibitions on mandatory arbitration clauses in consumer contracts."[4]

Their analysis, part of the *Mercatus Working Paper* series, exposes the many shortcomings of the CFPB's data. For example, Johnston and Zywicki criticize the CFPB's lack of information on the amount of arbitral settlements, as well as the report's use of aggregate averages, which skews results by "overweight[ing] data from only half a dozen huge class action settlements."

As though anticipating the *Sanchez* opinion, the report concluded by condemning the CFPB for ignoring the "robust and evolving jurisprudence [the courts have developed] to protect consumers in cases involving unfair arbitration clauses." In a striking coincidence, the same day the critique was published, the California Supreme Court would add to that developing body of case law by issuing its decision in *Sanchez*.

BACKGROUND: THE UNDERLYING CLASS-ACTION

Plaintiff Gil Sanchez filed a class-action lawsuit against Valencia Holding Company LLC in March 2010. The dispute arose out of plaintiff's 2008 purchase of a "preowned" Mercedez-Benz. As part of the transaction, Sanchez executed a standard, preprinted retail installment sale contract. Sanchez proposed four separate classes, alleging that Valencia violated California's Consumer Legal Remedies Act by making false representations about the condition of the automobile.

Sanchez also alleged that Valencia broke several other state laws by:

- Failing to separately itemize the amount of the down payment that is deferred to a date after the execution of the sale contract.
- Failing to distinguish registration, transfer, and titling fees from license fees.
- Charging the optional Department of Motor Vehicles electronic filing fee without discussing it or asking if he wanted to pay it.

CONSUMER FINANCIAL SERVICES LAW REPORT (USPS 017-468) (ISSN 1098-9315) is published 21 times a year. Published and copyrighted by Thomson Reuters, 610 Opperman Drive, P.O. Box 64526, St. Paul, MN 55164-0526. Periodical postage paid at St. Paul, MN. Please address correspondence to: Richard.Hoffmann@thomsonreuters.com. Customer Service: (800) 328-4880. POSTMASTER: Send address changes to CONSUMER FINANCIAL SERVICES LAW REPORT, 610 Opperman Drive, P.O. Box 64526, St. Paul, MN 55164-0526

- Charging new tire fees for used tires.
- Requiring Sanchez to pay $3,700 to have the vehicle certified so he could qualify for the 4.99 percent interest rate, when that payment was actually for an optional extended warranty unrelated to the interest rate.

Valencia moved to compel arbitration.

THE ARBITRATION CLAUSE

The preprinted contract containing the arbitration clause was 26 inches long and 8.5 inches wide. The buyer initialed and signed on the front of the contract. The arbitration clause appeared on the back. No signatures, initials, or other handwriting appeared on the back. The clause included a class-action waiver.

The trial court denied the motion to compel arbitration on Sept. 14, 2010. Under the CLRA, class-action litigation is an unwaivable right that is expressly authorized. Thus, in a pre-*Concepcion* landscape, the class-action waiver in the arbitration clause here was unenforceable. Moreover, the arbitration clause provided that the entire clause "shall be unenforceable" if the class-action waiver were found to be unenforceable.

Valencia appealed the denial on October 12, 2010. Six months or so later, *Concepcion* was decided on April 27, 2011. The U.S. Supreme Court considered whether the California Supreme Court's *Discover Bank*[5] rule was preempted by the FAA. The *Discover Bank* Court had held that class-action waivers in arbitration provisions are unconscionable in contracts of adhesion "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."[6]

The district court in *Concepcion* found the arbitration provision was unconscionable because "AT&T had not shown that bilateral arbitration adequately substituted for the deterrent effects of class actions."[7] The 9th U.S. Circuit Court of Appeals affirmed, finding the provision unconscionable under California law, and that the *Discover Bank* rule was not preempted by the FAA.

The 5-4 *Concepcion* decision authored by Justice Antonin Scalia reversed the 9th Circuit, holding that California's *Discover Bank* rule "interferes with arbitration" and "stands as an obstacle to the accomplishment and execution of full purposes and objectives of Congress." As such, the Court held that the *Discover Bank* rule was preempted by the FAA.

The California Court of Appeal issued its decision in *Sanchez* on Oct. 24, 2011 —approximately six months after *Concepcion*. Notably, that court declined to decide whether the class waiver was enforceable. Instead, it found other provisions of the arbitration agreement were unconscionable. Valencia sought review of the Court of Appeal's decision. On March 21, 2012, the California Supreme Court granted certiorari.

SANCHEZ: NOTHING LEFT THAT WOULD 'SHOCK THE CONSCIENCE'

On appeal, both parties were joined by *amici* — for Valencia, the California Chamber of Commerce, California New Car Dealers Association, American Financial Services Association, Nissan, Toyota, and General Motors, among others; for Sanchez, the Consumer Attorneys of California and Consumers for Auto Reliability and Safety joined in.

The primary thrust of the argument in favor of Valencia's position was that, after *Concepcion*, the extraordinary circumstances that would allow a court to refuse to enforce contractual arbitration on unconscionability grounds are limited. In other words, *Concepcion* has broad application, and it must not be interpreted as applicable only to class-action waivers in arbitration clauses. Thus, the Court of Appeal's avoidance of that issue in *Sanchez*, topped by the finding that other provisions of the arbitration clause were unconscionable, did not escape the *Concepcion* Court's mandate that the FAA limits the use of unconscionability to refuse to enforce arbitration clauses.

Sanchez argued that both the trial court and the Court of Appeal followed California's general law of contracts, noting that the Supreme Court itself recognized that unconscionability remains a generally applicable defense to arbitration agreements. Under California's well-settled law of unconscionability, Sanchez argued, the appellate decision should be affirmed because the arbitration provision was both procedurally and substantively unconscionable.

Asking the Court to adopt a multi-factor test to analyze unconscionability, Sanchez carefully noted that "[t]hese factors enable courts to evaluate contract terms based on the type of contract at issue, without favoring or disfavoring arbitration clauses. These factors are equally applicable to loan agreements and sales contracts as they are to settlement agreements."[8]

The *Sanchez* Court invited supplemental briefing in response to four questions:

- Should the court use only one of these formulations in describing the test for substantive unconscionability and, if so, which one?
- Are there any terms the court should not use?

- Is there a formulation not included among those above that the court should use?
- What differences, if any, exist among these formulations either facially or as applied?

Both parties responded that the Court should adopt a uniform standard. Valencia, supported by numerous *amici*, argued in favor of the "shocks the conscience" standard. Valencia posited this standard is the best choice because it is neither over-inclusive nor under-inclusive. Moreover, it is an objective standard based on what "reasonable people of common sense find not just unfair or one-sided, but reflecting an outcome that no reasonable person would have voluntarily agreed to."[9]

Sanchez and his *amici* derided Valencia's proposed "shocks the conscience" standard as an attempt to "push the envelope to the edge of the table, so that it is dangling off, just so long as it doesn't fall." Describing "Corporate America's" proposed test as "so impossible to establish ... it appears Goliath not only wishes to prohibit slingshots, but to strap David to a table and crush his skull with a boulder."[10]

Instead, Sanchez proposed a two-part test for substantive unconscionability: (1) Are the terms in question within the reasonable expectations of the consumer given the nature of the transaction? (2) Would a reasonable consumer, if he or she had the opportunity to accept or reject the terms, accept the terms? If the answer to either question is no, Sanchez posited, then the term in question should not be enforced.[11]

CLASS WAIVERS OK, THE REST IS JUST A (SHOCKINGLY?) BAD BARGAIN

Sanchez left few stakeholders in the debate fully satisfied. The majority opinion, written by Justice Liu and joined by Chief Justice Cantil-Sakauye and Justices Werdegar, Corrigan, Cuéllar, and Kruger, reversed the Court of Appeal's ruling that the arbitration agreement was unenforceable as unconscionable.[12]

The Court started by discussing the generally accepted principle that a contract provision must be both procedurally and substantively unconscionable in order to be deemed unenforceable. There is a sliding scale: "[T]he more substantively oppressive a contract term, the less evidence of procedural unconscionability is required to come to the conclusion that the term is unenforceable, and vice versa."[13]

The Court then "reaffirmed" that the "shock the conscience" standard — often but not exclusively used in the past — was neither unique nor the only correct standard for determining whether a contract is substantively unconscionable.[14] The Court concluded that different standards used in the past, including "overly harsh," "unduly oppressive," and "unreasonably favorable … all mean the same thing."[15] The question for courts in evaluating substantive unconscionability is to ask whether there has been "a substantial degree of unfairness beyond a simple old-fashioned bad bargain."[16]

Valencia, for its part, first had contended that under *Concepcion*, "absent exceptional circumstances . . . [the Court] may not, under the guise of unconscionability, judge the supposed fairness of the parties' agreed arbitration process."[17] The Court rejected this argument and read *Concepcion* less broadly. The U.S. Supreme Court did make clear that state law unconscionability doctrines may not "disfavor arbitration as applied by imposing procedural requirements that" frustrate its features, including affordability and "efficiency."[18]

But, nevertheless, state law unconscionability principles may implicate the arbitration process as long as they do not frustrate the fundamental purposes of arbitration. The Court, as an example of a permissible limitation, said that a high appeal threshold that favored defendants is still potentially impermissible after *Concepcion*.

Valencia then argued that the Court of Appeal erred in holding the provision unconscionable under California law. While there was no dispute that the agreement was "adhesive" (i.e., Sanchez could not opt-out of the arbitration provision or negotiate to modify it), Valencia contended that this did not make the contract procedurally unconscionable.

The Court found that the contract had "some degree of procedural unconscionability,"[19], and therefore proceeded to examine, on a sliding scale, whether it also was substantively unconscionable. The Court considered four different bases for potential substantive unconscionability and ultimately rejected all of them.

- First, the agreement contained a provision permitting a request for a second arbitration in front of a three-arbitrator panel if the award was $0 or any amount greater than $100,000. In *Little v. Auto Stiegler, Inc.* 29 Cal. 4th 1064 (Cal. 2003), the Court had held unconscionable a provision that allowed the respondent to appeal if the arbitrator awarded more than $50,000. Valencia distinguished Little on three grounds (1) here a claimant who loses can appeal, (2) the award needed for respondent to appeal is $100,000 rather than $50,000, and (3) because *Little* concerned an employment agreement, the context favored more concern for fairness to the claimant than in the automobile sales context. The Court rejected Sanchez's argument: "We cannot say that the risks imposed on the parties are one-sided, much less unreasonably so."[20]

- Second, the Court considered the unconscionability of a provision that permitted an appeal in the event that the arbitrator granted injunctive relief. Valencia conceded that the buyer is more likely than the dealership to pursue an injunction but emphasized that such injunctions may be broad in nature and require a modification of practices by the dealership that range far beyond the individual transaction at issue. The Court found this compelling, concluding that this ability to appeal, even though more likely to be invoked by dealerships, is permissible due to the "potentially far-reaching nature" of the type of injunctions that may be entered against dealerships in automobile sales arbitrations.[21]
- Third, the Court of Appeal's decision also had relied on the unconscionability of a provision that required the party seeking to request another arbitration in front of the three-arbitrator panel to pay the filing and other administrative fees, subject to apportionment at the end of the case. Under the agreement, the dealership had to advance the first $2,500 in fees for the first arbitration, also subject to apportionment. Again distinguishing employment-related arbitration provisions that the Court believed present a more vulnerable position for the weaker party (job applicants v. automobile purchasers), the Court concluded that this provision was not unconscionable due to the lack of a "showing that appellate fees and costs in fact would be unaffordable or would have a substantial deterrent effect in Sanchez's case."[22]
- Fourth, the agreement exempted self-help remedies from arbitration, which in this context primarily meant repossession of a vehicle after non-payment. Unlike the Court of Appeal, the California Supreme Court roundly rejected this as a basis for unconscionability for several reasons: (1) even if the repossession exemption favored dealerships, small claims cases were also exempted which favored buyers, (2) self-help is by definition statutory authorized to take place outside of litigation, and therefore failing to include it in an alternative to litigation cannot make an agreement unconscionable, and (3) "it is undisputed that the remedy of repossession of collateral is an integral part of the business of selling automobiles on credit and fulfills a 'legitimate commercial need."[23]

Having rejected all four of the grounds, the California Supreme Court concluded that the arbitration provision was not unenforceable as unconscionable. The Court then addressed whether, post-*Concepcion*, the class-action waiver provision of the agreement was enforceable. Notably, the Court of Appeal decision, issued post-*Concepcion*, did not address this issue.

The state Supreme Court explained that, while the CLRA contains a provision that bars waiver of the right to bring a CLRA class action, *Concepcion* stated that no state law procedure may interfere with the "fundamental attributes of arbitration."[24] Observing that this CLRA provision "disfavors arbitration as applied" and "as a practical matter" because it "interferes with arbitration's fundamental attributes of speed and efficiency," the Court concluded that *Concepcion* preempted the CLRA's anti-waiver provision.[25] Accordingly, the Court held that the unconscionability doctrine did not invalidate the class waiver either.

In sum, the Court concluded that Valencia was not barred from enforcing the arbitration provision "on unconscionability grounds"[26], including its class waiver.[27]

IS THERE A CLEAR ANSWER TO ENFORCEABILITY POST-*SANCHEZ*?

Given the level of interest in and mounting anticipation surrounding the California Supreme Court's decision, it is hardly surprising that *Sanchez* already features prominently in a number of cases deciding whether to compel arbitration. These cases help us see the breadth of Sanchez's impact and underscore likely questions in the post-*Concepcion* landscape.

On the one hand, in a putative class action pending in the Northern District of California, Judge Koh relied on *Sanchez* to enforce the arbitration agreement and its class action waiver provision over Plaintiff's objection that it was not sufficiently conspicuous.[28]

On the other hand, in a wrongful termination case, the California Court of Appeal rejected the employer's assertion that the U.S. and California Supreme Courts interpreted the FAA to mean that an arbitration agreement must be enforced even if the agreement is substantively unconscionable.[29] In refusing to enforce a one-sided arbitration clause, the appellate court noted that *Sanchez* tells us the same unconscionability standard applies to both arbitration and nonarbitration contracts.

The most obvious question that remains is: What degree of unfairness is required to find unconscionability? We know it must be beyond merely a "bad bargain."

In weighing such decisions, perhaps the bigger question is whether courts in California will move in the direction of their highest court, find "legitimate business needs" to be a persuasive factor in enforcing

the parties' agreements, and be less receptive to unconscionability arguments to invalidate arbitration clauses.

Notes

[1] Consumer Financial Protection Bureau, *Arbitration Study Report to Congress, Pursuant to Dodd-Frank Wall Street Reform and Consumer Protection Act § 1028(a)* (2015), *available at* consumerfinance.gov/reports/arbitration-study-report-to-congress-2015/

[2] Letter from Senator McHenry *et al* to Richard Cordray, Consumer Financial Protection Bureau (June 17, 2015) *available at* cfpbmonitor.com/files/2015/06/McHenry-Scott-to-Cordray-Letter-re-Arbitration.pdf

[3] Letter from American Bankers Association *et al* to Richard Cordray, Consumer Financial Protection Bureau (July 13, 2015) *available at* cfpbmonitor.com/2015/07/14/trade-groups-comment-on-cfpb-final-arbitration-study-results/.

[4] Jason Scott Johnston and Todd Zywicki. "The Consumer Financial Protection Bureau's Arbitration Study: A Summary and Critique." Mercatus Working Paper, Mercatus Center at George Mason University, Arlington, VA, August 2015 *available at*/mercatus.org/sites/default/files/Johnston-CFPB-Arbitration.pdf, *See also,* mercatus.org (describing the Mercatus Center at George Mason University as "a university-based research center). The authors' publication further notes: "All studies in the Mercatus Working Paper series have followed a rigorous process of academic evaluation, including (except where otherwise noted) at least one double-blind peer review."

[5] *Discover Bank v. Superior Court*, (2005) 36 Cal.4th 148 (2005).

[6] *AT&T Mobility LLC v. Concepcion*, 131 S.Ct. 1740 (2011).

[7] *Id*. (citing *Laster v. T-Mobile USA, Inc*., 2008 WL 5216255, (S.D. Cal. 08/11/08)).

[8] Respondent's Consolidated Answer to Briefs as *Amici Curiae* at *Sanchez v. Valencia Holding Co., LLC,* No. S199119.

[9] Appellant's Supplemental Brief on the Merits at 24-25, *Sanchez v. Valencia Holding Co., LLC,* No. S199119.

[10] Respondent's May 18, 2014 Response to Appellants' Supplemental Brief and Amicus Supplemental Briefs, *Sanchez v. Valencia Holding Co., LLC,* No. S199119.

[11] Respondent's March 11, 2014 Response to Request for Supplemental Brief at 3, *Sanchez v. Valencia Holding Co., LLC,* No. S199119.

[12] *Sanchez v. Valencia Holding Co., LLC,* No. S199119., 2015 WL 4605381 (Cal. 08/03/15), The Court's entire opinion *available at* courts.ca.gov/opinions/documents/S199119.pdf (hereinafter "Opinion").

[13] Opinion at 7 (quoting *Armendariz v. Foundation Health Psychare Services, Inc.* (2000) 24 Cal. 4th 83, 114).

[14] Opinion at 8.

[15] *Id.* at 9.

[16] *Id*. (quoting *Sonic-Calabasas A, Inc. v. Moreno* (2013) 57 Cal. 4th 1109, 1143-45).

[17] *Id.* at 10.

[18] *Id.* at 11.

[19] *Id.* at 14.

[20] *Id.* at 16.

[21] *Id.* at 17.

[22] *Id.* at 22.

[23] *Id.* at 25 (quoting *Armendariz, supra*, 24 Cal. 4th at 117).

[24] *Id.* at 26.

[25] *Id.* at 27.

[26] *Id.*

[27] In a lengthy separate opinion, Justice Chin concurred in part, concurred in the judgment, and dissented in part. Justice Chin concluded that the record did not demonstrate either procedural unconscionability or substantive unconscionability and asserted that the Court should consistently apply the "shock the conscience" standard to unconscionability analysis. J. Chin Opinion at 17.

[28] *Dang v. Samsung Elecs. Co.,* 2015 U.S. Dist. LEXIS 105594 at *16 (N.D. Cal. 08/10/15).

[29] *Carlson v. Home Team Pest Defense, Inc.*, 2015 Cal.App. LEXIS 702, (08/17/15) (finding substantive unconscionability where the "principal concern with the Agreement rests on its failure to hold [the employer] to the same obligation to *arbitrate* that it holds [the employee]").

