By Stephen D. Feldman and Kelly Margolis Dagger

Recent Appellate Decisions Reshape Landscape

For in-house counsel who draft and enforce arbitration agreements, following the fast-moving landscape of arbitration law is a meaningful challenge. Over the last three years, the U.S. Supreme Court has issued three major decisions that affect the enforceability of arbitration agreements. State appellate courts have then applied those decisions in varying ways. This article examines the key rulings and concepts in these seminal Supreme Court decisions.

The FAA and Key Defenses to Enforceability of Arbitration Agreements

When it passed the Federal Arbitration Act, Congress declared a "liberal federal policy favoring arbitration agreements." *Moses H. Cone Mem'l Hosp. v. Mercury Constr. Corp.*, 460 U.S. 1, 24 (1983).

In view of that policy, section 2 of the FAA provides that written agreements to arbitrate disputes in contracts involving transactions in interstate commerce "shall be 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. To paraphrase section 2, when the FAA applies to an arbitration agreement, the agreement will be enforced unless a generally applicable contract defense precludes enforcement. For example, an arbitration agreement induced by fraud or duress would be unenforceable. *Doctor's Assocs., Inc. v. Casarotto*, 517 U.S. 681, 687 (1996).

The Supreme Court's recent decisions on arbitration have focused on two often-overlapping defenses to enforceability. To be clear, the party that wants to avoid arbitration—the plaintiff, usually—would assert these defenses in response to the adverse party's motion to compel arbitration.

The first defense is that arbitration is prohibitively expensive. Put another way, the plaintiff who invokes this defense argues that cost of the arbitration—including filing fees, witness fees, attorney fees, and any other costs—exceeds the amount that could be recovered in the arbitration.

The second defense concerns class-action waivers. Arbitration agreements commonly contain a provision where the parties waive any right to pursue potential claims in a class-action proceeding. In other words, a potential plaintiff agrees to bring her claims only individually in arbitration. Class-action waivers prevent plaintiffs from sharing costs, such as attorney and witness fees, with other similarly situated plaintiffs.

To avoid the enforcement of class-action waivers, and as this article discusses below, plaintiffs have invoked various state-law doctrines to argue that class-action waivers invalidate an arbitration agreement. For example, many plaintiffs have argued that arbitration agreements that contain class-action waivers are unconscionable because they deter small claims; a rational plaintiff will not bring a claim in arbitration when the cost of pursuing the claim individually exceeds any potential recovery.

Thanks to the Supreme Court's recent decisions, this argument against the enforceability of class-action waivers may no longer be viable. In particular, and as discussed more fully below, the Supreme Court's decisions lead to a harsh conclusion for plaintiffs: When a state law invalidates an arbitration agreement because the agreement contains a class-action waiver, the state law is likely preempted by the FAA, even if the result is that no rational plaintiff will bring an individual claim in arbitration.

The Development of the Effective-Vindication Defense

A starting point to understand the Supreme Court's recent arbitration decisions is the Supreme Court's 1985 decision in *Mitsubishi Motors Corp. v. Soler Chrysler-Plymouth, Inc.*, 473 U.S. 614 (1985).

In *Mitsubishi Motors*, the Supreme Court considered whether a party could avoid arbitration because that party wanted to assert a federal statutory cause of action not specifically mentioned in the parties' arbitration agreement. *See id.* at 624–25. The Supreme Court held that the assertion of the federal statutory claim did not allow the party to avoid the arbitration agreement. *Id.* at 637. The key question, according to the Court, is whether the party can effectively vindicate its federal statutory cause of action in the arbitral forum. *Id.* If the answer is yes, then the party cannot avoid arbitration merely because it intends to assert a federal statutory claim. *Id.*

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In 2000, the Supreme Court revisited these concepts and more expressly acknowledged an effective-vindication defense. *See Green Tree Fin. Corp.-Ala. v. Randolph*, 531 U.S. 79, 90 (2000). That defense has potency, the Supreme Court explained, when "the existence of large arbitration costs could preclude a litigant… from effectively vindicating her federal statutory rights in the arbitral forum." *Id.* The Supreme Court tasked the party asserting the defense—that is, the party that wants to avoid arbitration—with showing the costs that the party would incur in arbitration exceed the amount the party could recover. *Id.* at 91.

Read together, the *Mitsubishi Motors* and *Green Tree* decisions appear to create an effective-vindication defense, based on federal common law, to the enforcement of an arbitration agreement when a party is alleging a federal statutory claim. In *Green Tree* in particular, the Supreme Court explained that an effective-vindication defense of federal statutory rights could reconcile competing congressional policies: (1) the FAA's policy in favor of arbitration, and (2) policies in other federal statutes that favor judicial resolution of certain claims. *Id.* at 90.

Following *Green Tree*, many state appellate courts imported the Supreme Court's effective-vindication analysis when evaluating, under state law, the enforcement of arbitration agreements. Notably, these state courts did so even if a party did not assert federal statutory claims. *See, e.g.*, *Tillman v. Commercial Credit Loans, Inc.*, 655 S.E.2d 362, 366 (N.C. 2008). Some state appellate courts tied the effective-vindication analysis to state-law unconscionability standards. These courts concluded that, if a party could not effectively vindicate a state statutory claim in arbitration, the arbitration agreement was substantively unconscionable and, therefore, invalid. *See, e.g.*, *Schnuerle v. Insight Commc'ns Co.*, 376 S.W.3d 561, 573 (Ky. 2012); *State ex rel. Richmond Am. Homes of W.V., Inc. v. Sanders*, 717 S.E.2d 909, 921 (W.V. 2011); *Tillman*, 655 S.E.2d at 373; *Vasquez-Lopez v. Beneficial Or., Inc.*, 152 P.3d 940, 952 (2007).

The Enforceability of Class-Action Waivers

Classwide arbitration is one way in which a plaintiff can cost-effectively pursue relief via arbitration. Defendants, however, would argue that the complexities of a class action overcome the core benefits of arbitration.

The Supreme Court addressed these arguments in *Stolt-Nielsen S.A. v. AnimalFeeds International Corp.*, 130 S. Ct. 1758, 1775 (2010). In *Stolt-Nielsen*, the parties entered into an arbitration agreement. That agreement, however, was silent as to whether a party could pursue a class action in the arbitration. The Supreme Court held that, in view of the agreement's silence on class actions, the plaintiff could *not* pursue class wide relief. *Id.* The Supreme Court reasoned that, because of the degree to which class proceedings alter arbitration, it cannot be assumed that the parties consented to *class* arbitration simply because they agreed to arbitrate their disputes. *Id.* at 1775.

> Although agreeing to pay a potential claimant's filing fees might appear to encourage the filing of claims, such a provision would have a greater benefit: foreclosing the litigation of a cost-prohibitiveness defense.

One year later, in *AT&T Mobility LLC v. Concepcion*, 131 S. Ct. 1740 (2011), the Supreme Court again examined the circumstances in which a party can assert, or be barred from asserting, a class action in arbitration proceedings. *Concepcion* concerned a California state-law rule that effectively barred class-action waivers in consumer arbitration agreements. Under this rule, a class-action waiver in an arbitration agreement is unconscionable—and, therefore, invalid—if the waiver was part of a "consumer contract of adhesion in a setting in which disputes between the contracting parties predictably involve small amount of damages." *Id.* at 1746 (quoting *Discover Bank v. Superior Ct.*, 113 P.3d 1100, 1110 (Cal. 2005)). Put another way, if an arbitration agreement in a consumer adhesion contract included a class-action waiver, and the arbitration clause was likely to cover small-damages claims, the California rule invalidated that agreement.

Concepcion argued that this rule, called the "*Discover Bank* rule," was preempted by the FAA. The Supreme Court agreed. A rule that requires classwide arbitration to be available, the Supreme Court said, "interferes with fundamental attributes of arbitration." *Id.* at 1748. That interference cannot be reconciled with the FAA's liberal policy in favor of arbitration and thus "creates a scheme inconsistent with the FAA." *Id.* at 1748.

Notably, the Supreme Court in *Concepcion* had no sympathy for plaintiffs with small-damages claims—and for whom a class action provides the only cost-effective method for seeking a recovery. In the words of the *Concepcion* Court, even if "class proceedings are necessary to prosecute small-dollar claims that might otherwise slip through the legal system[,]… States cannot require a procedure that is inconsistent with the FAA." *Id.* at 1753.

Appellate Courts' Varying Decisions on Class-Action Waivers

Following *Concepcion*, state and federal appellate courts struggled to interpret that decision uniformly. These decisions can be divided into three categories.

Narrow Interpretations of Concepcion

One group of appellate courts interpreted the FAA's preemptive scope under *Concepcion* to be narrow. These decisions concluded that the FAA preempts only state-law rules that mirror the *Discover Bank* rule—state-law rules that, in large part, *automatically* invalidate class-action waivers. See *Franco v. Arakelian Enters.*, 149 Cal. Rptr. 3d 530, 533 (Cal. Ct. App. 2012), *review granted*, 294 P.3d 74 (Cal. 2013); *Feeney v. Dell Inc.*, 465 Mass. 470 (2013); *Kelker v. Geneva-Roth Ventures, Inc.*, 369 Mont. 254, *3 (2013); *Brewer v. Mo. Title Loans*, 364 S.W.3d 486, 491 (Mo. 2012).

For these courts, the FAA's preemptive effect under *Concepcion* turns on the nature of the state-law rule used to evaluate the validity of a class-action waiver. *See Brewer*, 364 S.W.3d at 491 (interpreting *Concepcion* to allow a "case-by-case approach" to class-action waivers); *Franco*, 149 Cal. Rptr. 3d at 533 (holding that FAA preempts only "a categorical rule against class action waivers"). If that state-law rule is more flexible than the *Discover Bank* rule, the FAA does not preempt that rule. And, if the state-law rule is not preempted, that rule—such as unconscionability—can be used as a framework to show that, if arbitration is compelled, the plaintiff cannot effectively vindicate her rights, even for non-federal claims, owing to the cost of arbitration. *See Feeney*, 465 Mass. at 505–06.

Expansive Interpretations of Concepcion

Another group of appellate courts have taken the polar opposite approach. These courts conclude that, under *Concepcion*, the FAA preempts *any* consideration of class-action waivers by any state-law rule used to evaluate the enforceability of an arbitration agreement. *See McKenzie Check Advance of Fla., LLC v. Betts*, 112 So. 3d 1176, 1187 (Fla. 2013); *Coneff v. AT&T Corp.*, 673 F.3d 1155 (9th Cir. 2012); *Cruz v. Cingular Wireless, LLC*, 648 F.3d 1205, 1212 (11th Cir. 2011); *Schnuerle*, 376 S.W.3d at 572.

In view of these courts' broad interpretation of *Concepcion*, plaintiffs in these jurisdictions are hard-pressed to argue that an arbitration agreement is invalid because a class-action waiver renders arbitration cost-prohibitive. *See, e.g., McKenzie*, 112 So. 3d at 1187. One of these courts, however, described how an effective-vindication claim based on the high cost of arbitration might remain viable. That decision, from the Supreme Court of Kentucky, said that plaintiffs can show that arbitration fees themselves are prohibitively high, or that the location of the arbitration is exceptionally remote. *Schnuerle*, 376 S.W.3d at 573.

Decisions Between the Polar Opposites

A third group of appellate courts falls within the two extremes of the first two categories. These courts view the FAA's preemptive effect after *Concepcion* to apply to state-law rules as more flexible than the *Discover Bank* rule. On the other hand, these courts do not wholly foreclose a party from pointing to the effects of a class-action waiver as an ingredient in an effective-vindication defense. *See, e.g., Muriithi v. Shuttle Express, Inc.*, 712 F.3d 173, 180–81 (4th Cir. 2013). *Concepcion*, after all, did not specifically address the effective-vindication defense enunciated in *Mitsubishi Motors* and *Green Tree*.

For example, the Court of Appeals of Wisconsin interpreted *Concepcion* to mean that "the FAA preempts any state law that classifies an arbitration agreement as unconscionable… simply because the agreement prohibits an individual from proceeding as a member of a class." *Cottonwood Fin., Ltd. v. Estes*, 810 N.W.2d 852, 858 (Wis. Ct. App. 2012). *Cottonwood* upheld an arbitration agreement that contained a class-action waiver, but that court did not discuss whether *Concepcion* foreclosed or allowed a court to analyze the effect of a class-action waiver through a case-by-case state-law rule.

Likewise, the Court of Appeals of Ohio enforced a class-action waiver—and upheld an arbitration agreement with that waiver—without concluding whether a class-action waiver could ever cut against enforcement of an arbitration agreement. *Wallace v. Ganley Auto Grp.*, No. 95081, 2011 WL 2434093, at *6–*7 (Ohio Ct. App. June 16, 2011). The West Virginia Supreme Court left open this question, too. *State ex rel. Richmond Am. Homes of W. Va., Inc. v. Sanders*, 717 S.E.2d 907, 920 (W. Va. 2011).

The Supreme Court Addresses Effective Vindication in the Context of Class-Action Waivers

These decisions set the stage for the Supreme Court's decision in June in *American Express Co. v. Italian Colors Restaurant*, 133 S. Ct. 2304 (2013) ("*AmEx III*"). In *AmEx III*, a restaurant argued that the class-action waiver in its arbitration agreement was invalid. More specifically, the restaurant said that, in the absence of a class action, the costs of proving its claims in individual arbitration would be too high to allow the restaurant to vindicate its rights under the Sherman Act. *Id.* at 2308. On three separate occasions, the Second Circuit agreed, holding that the plaintiffs had made a sufficient showing of prohibitive costs to avoid arbitration. According to the Second Circuit, *Concepcion* did not alter *Green Tree* and, therefore, the effective-vindication defense remained viable.

The Supreme Court disagreed. The effective-vindication defense, the Court explained, prevents a party from prospectively waiving its "*right to pursue*" statutory remedies. *Id.* at 2310 (quoting *Mitsubishi Motors*, 473 U.S. at 637) (emphasis in *AmEx III*). The right to *pursue* a statutory remedy, the Supreme Court said, does not guarantee a cost-effective pursuit. In the Court's words, "the fact that it is not worth the expense involved in **proving** a statutory remedy does not constitute the elimination of the **right to pursue** that remedy." *Id.* at 2311. At bottom, the *AmEx III* decision precludes a party from avoiding arbitration based on the financial impracticality of pursuing a complex small-dollar claim in non-class arbitration.

This decision, however, did leave open some room for an effective-vindication defense, but not one based on the inability to bring a class action. The effective-vindication exception, the Supreme Court explained, would apply to an arbitration agreement that forbids the assertion of certain statutory rights. *Id.* at 2310. Large filing and administrative fees, too, could justify an effective-vindication defense. *Id.* at 2311.

Justice Kagan wrote a stinging dissent. She called the decision "a betrayal of our precedents." *Id.* at 2313. Pointing to *Mitsubishi Motors* and *Green Tree*, the dissent showed that the effective-vindication rule serves "to prevent arbitration clauses from choking off a plaintiff's ability to enforce congressionally-created rights." *Id.*

The dissent also explains how the federal policy favoring arbitration is a policy that favors the *method* of dispute resolution, not the killing off of valid claims. *Id.* at 2315. Consistent with this policy, the effective-vindication rule ensures that arbitration is a real, viable method of dispute resolution. *Id.* Without the effective-vindication rule, "companies have every incentive to draft their agreements to extract backdoor waivers of statutory rights, making arbitration unavailable or pointless." *Id.*

Enforcing Class-Action Waivers After *AmEx III*

The *AmEx III* decision leaves open several important questions for parties that seek to

enforce arbitration agreements with class-action waivers. First, it is not clear how the Court's reasoning will affect state-law unconscionability doctrine. The state appellate courts that have adopted some version of the effective-vindication defense, and that have smuggled that analysis into state-law rules of substantive unconscionability, can characterize *AmEx III* as a decision of federal common law concerning the arbitrability of federal statutory causes of actions. By comparison, the state courts that have interpreted *Concepcion* to allow the consideration of the effects a class-action waiver as part of a case-by-case unconscionability analysis might simply continue to apply that analysis, also limiting *AmEx III*'s definition of effective vindication to federal statutory rights.

One particular area of interest for state appellate courts might be *AmEx III*'s explicit carve-out for "an arbitration agreement forbidding the assertion of certain statutory rights." Even if the effective-vindication analysis that has bled into state-law unconscionability doctrine is largely defunct after *AmEx III*, the decision leaves the effective-vindication defense with a pulse, albeit a weak one. Conceivably, an arbitration agreement that purports to prohibit the assertion of remedial statutory rights, such as the recovery of attorney fees or double or treble damages, could still be invalidated on effective-vindication grounds.

As a final point, and in view of *AmEx III*, attorneys charged with drafting arbitration clauses should avoid any provisions that could be perceived as prospective waivers of statutory rights. Given that is unclear whether the *AmEx III* Court spoke to an explicit waiver—"I agree to waive any and all claims under the Fair Labor Standards Act"—or a more functional waiver—"I agree that the law of State X will apply," where State X does not recognize a fraud claim—drafters should err on the side of caution as the law in this area develops.

As to the costs and fees associated with the arbitral forum, drafters might consider including a fee-shifting provision that forgives the individual claimant's filing fees. Although agreeing to pay a potential claimant's filing fees might appear to encourage the filing of claims, such a provision would have a greater benefit: foreclosing the litigation of a cost-prohibitiveness defense. Arbitration filing fees might be a small price to pay to avoid time-consuming and costly litigation over the enforceability of the arbitration agreement.