

Letting the arbitrator decide? Unconscionability and the allocation of authority between courts and arbitrators

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Introductory example

- *Armendariz v. Foundation Health Psychcare Services, Inc.* (California Supreme Court, 2000): wrongful termination and sexual harassment claims under CA statute; court held the arbitration clause in the employment contract was unconscionable.

Question: what if the court had held that the issue of unconscionability was for the arbitrator to decide?

Letting the arbitrator decide unconscionability: examples

- Unconscionability challenge (e.g.: adhesion contract argument) is directed to the entire contract.
- Allegedly unconscionable provision (e.g.: punitive damages waiver) is unrelated to arbitration clause.
- Parties contracted for the arbitrator to determine whether the arbitration clause is unconscionable.

Theme

- The U.S. allocation rule is evolving towards “letting the arbitrator decide” arbitrability. Such a rule may support arbitration in the commercial sphere, but could undermine arbitration in the consumer/employment contract sphere by removing an important check on one-sided agreements.
- Adopting legislative restrictions on mandatory arbitration (similar to those in effect in France and other countries) is a possible solution.

Roadmap

1. Background to unconscionability and arbitration, and to “who decides” arbitrability questions.
2. Recent case law on “letting the arbitrator decide” unconscionability challenges.
3. Comparative perspective.
4. Legislative proposals to limit mandatory arbitration.
5. Conclusions.

Unconscionability and arbitration

Federal Arbitration Act (FAA) Section 2:

Provides that an arbitration agreement “shall be valid, irrevocable, and enforceable, save upon such grounds as exist at law or in equity for the revocation of any contract.”

Unconscionability and arbitration (cont'd)

Two limitations:

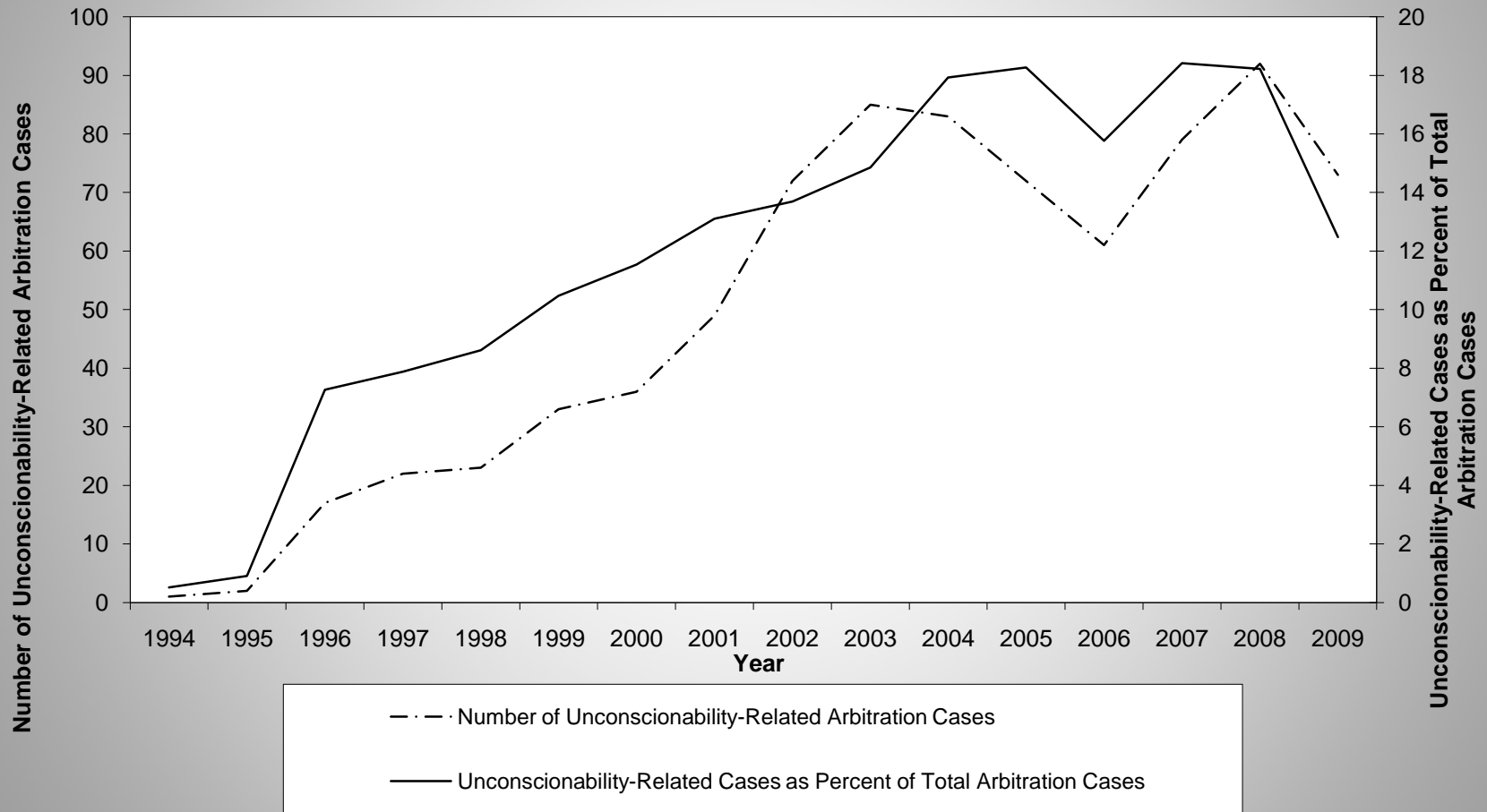
1. Any challenge on grounds that arbitration *per se* is unconscionable will be preempted by the FAA (*Southland v. Keating*, USSC, 1984).
2. Any challenge that is directed to the entire contract (as opposed to the arbitration clause) is for the arbitrator to decide (*Prima Paint*, USSC, 1967).

Unconscionability and arbitration (cont'd)

Analogous to unconscionability challenges are challenges to the enforceability of the arbitration clause on grounds that the arbitration agreement prevents plaintiff from enforcing the statutory rights underlying the claim.

e.g.: Greentree v. Randolph (USSC, 2001)(high arbitration costs allegedly precluded plaintiff from vindicating her rights under the Truth in Lending Act).

The “Unconscionability Game” (Bruhl article)



“Who decides” arbitrability

Two “arbitrability” questions:

- (i) whether the dispute falls within the scope of the arbitration clause; and
- (ii) whether there is an enforceable agreement to arbitrate.

“Who decides” arbitrability (cont’d)

- *Prima Paint* (USSC, 1967): challenge that the entire contract was fraudulently induced was for the arbitrator to decide.
 - *Buckeye Check Cashing* (USSC, 2006): alleged illegality of lending contract charging usurious interest was for the arbitrator to decide; possibility that entire contract may later be found to be void was insufficient reason to invoke an exception to *Prima Paint*.

“Who decides” arbitrability (cont’d)

- *AT&T* (USSC, 1986): issue of whether a dispute is arbitrable “is undeniably an issue for judicial determination.” Whether dispute fell within scope of the arbitration clause was for the court to decide.
 - But *cf. Howsam* (USSC, 2002): arbitrator should decide whether the limitations rule of the NASD’s Code of Arbitration Procedure had been met;
 - and *Bazzle* (USSC, 2003): arbitrator should decide whether the contract authorizes class arbitration.

“Who decides” arbitrability (cont’d)

- *First Options* (USSC, 1995): issue of whether court or arbitrator has “primary authority” to decide arbitrability hinges on what the parties agreed:
 - If the parties agreed to arbitrate arbitrability, then the arbitrator’s decision (on whether there was an agreement to arbitrate) should be subject to deferential review under the FAA.
 - “Courts should not assume that the parties agreed to arbitrate arbitrability unless there is ‘clear and unmistakable’ evidence that they did so.”

First Options and judicial review

- FAA Section 10(a) lists the grounds on which a reviewing court may vacate an arbitral award:
 - 1) Award procured by corruption or fraud
 - 2) Evident partiality in the arbitrators
 - 3) Arbitrator misconduct
 - 4) Where the arbitrators exceeded their powers
- Significance of FAA §10(a)(4) is that it provides for *de novo* review of the arbitrator's jurisdictional findings (*cf. First Options*, which in effect allows parties to contract for deferential review).

Letting the arbitrator decide: three categories of unconscionability decisions

1. Challenges to the entire contract: expanding the rule in *Prima Paint*.
2. Challenges to ancillary contract provisions: *Pacificare* and related cases.
3. Enforcing the parties' agreement to let the arbitrator decide his or her jurisdiction under the rule in *First Options*.

Expanding *Prima Paint*

- *Nagrampa* (9th Cir., 2005): plaintiff’s “contract of adhesion argument” was for the arbitrator to decide; accordingly, court “need not reach” argument that the arbitration clause was substantively unconscionable.
 - Although *Nagrampa* was later reversed en banc, three of the 9th Circuit judges dissented.
 - See also *Jenkins* (11th Cir., 2005): procedural unconscionability is for the arbitrator to decide.

Challenges to “ancillary” provisions

- *Pacificare* (USSC, 2003): whether contractual ban on punitive damages acted as a bar to statutory damages under RICO was for the arbitrator to decide as an initial matter.
 - In a footnote, the Court characterized the issue in the case as not raising a “question of arbitrability.”
 - Circuit courts previously had found punitive damages waivers as “not relevant” to the enforceability of the arbitration clause: *Peacock* (3rd Cir., 1997); *Larry’s United Super* (8th Cir., 2001).

“Ancillary” provisions (cont’d)

- This rationale has also been applied to allegations of unconscionability:
 - *Hawkins* (7th Cir., 2003): alleged unconscionability of punitive damages, attorneys’ fees and class action waivers are for the arbitrator to decide, on grounds that such provisions have “nothing to do with” the existence or scope of the arbitration agreement.
 - *Bob Schultz Motors* (8th Cir., 2003): arbitral finding that costs allocation clause is unconscionable does not render arbitration agreement unenforceable.

Private agreement: *First Options*

- *Terminix* (11th Cir., 2005): claim under Florida Deceptive and Unfair Practices Act; reference to AAA procedural rules in arbitration clause amounts to “clear and unmistakable” evidence of intent to have the arbitrator decide whether the contract was unenforceable.
 - Federal district courts also have followed *First Options* in unconscionability cases, finding “clear and unmistakable evidence” of intent on the basis of a standard form clause, employee handbook or arbitral rules (N.D. Ca., S.D. Miss., N.D. Ohio, N.D. Ill., E.D. NY).
 - *See, e.g.,* Vidrine v. Balboa Ins. (S.D. Miss., 2009).

Private agreement (cont'd)

- *Cf. Awuah* (1st Cir., 2009): found “clear and unmistakable evidence” under *First Options*, but invoked public policy to allow court review of whether the class action waiver would render arbitration an illusory remedy.
- *Cf. Jackson* (9th Cir., 2009): unconscionability challenge is for the court to decide, even if the contract states otherwise; no “clear and unmistakable evidence” of intent due to lack of meaningful assent on part of employee.

Summary

- The evolving federal approach to “who decides” arbitrability could make arbitration law more consistent and transparent BUT
- This approach also significantly weakens the unconscionability safeguard in the mandatory arbitration context, and eventually may provoke a legislative response.
- The *First Options* standard (allowing parties to contract around the allocation rule) should be overruled or narrowly construed.

Limiting *First Options*

- *First Options* might plausibly be limited to two situations:
 1. Where the issue is whether the matter falls within the scope of an otherwise valid arbitration clause; and
 2. Certain post-dispute submissions of arbitrability to the arbitrator:
 - Facts of *First Options*
 - *See also L.G. Caltex Gas* (English Court of Appeal, 2001)

Comparative perspective

1. Timing of judicial review: spectrum of approaches

Access to judicial review
before or during
arbitral hearing

US
(*AT&T*)

UNCITRAL model
law countries

Access restricted until
award enforcement
stage

France



Comparative perspective (cont'd)

2. Consumer disputes

- EU Council Directive 93/13/EEC (1993) on unfair terms in consumer contracts: generally precludes mandatory arbitration of consumer disputes.
 - Does not apply to “individually negotiated” contract terms.
 - *Mostaza Claro v. Centro Movil Milenium* (ECJ, 2006): Directive 93/13 requires Spanish court to annul arbitral award based on unfair arbitration clause in consumer contract, although consumer participated in arbitration without challenging the clause.

Comparative perspective (cont'd)

3. Employment disputes

- A number of countries prohibit the use of arbitration (or pre-dispute arbitration clauses) to resolve employment disputes.
 - French Labor Code: *Conseil des Prud'hommes* has exclusive jurisdiction to resolve employment disputes.
 - Other examples: Belgium, Italy, Japan, Austria, Poland, Hungary, Bulgaria.

Legislative proposals

1. Arbitration Fairness Act of 2009 (H.R. 1020; S. 931): would render unenforceable any pre-dispute agreement to arbitrate consumer, employment or franchise disputes.
2. Consumer Fairness Act of 2009 (H.R. 991): would prohibit pre-dispute arbitration clauses in consumer contracts.

Legislative proposals (cont'd)

- Bills to limit mandatory arbitration have been introduced to the House or the Senate for well over a decade without success:
 - Civil Rights Procedures Protection Act of 1994, 1995, 1996, 1997, 1999, 2001 (limited to certain statutory claims).
 - Arbitration Fairness Act of 2002.
 - Arbitration Fairness Act of 2007 (almost identical to the 2009 bill).

Legislative proposals (cont'd)

- But recent events suggest that momentum against mandatory arbitration is building:
 - Minnesota attorney general's suit against National Arbitration Forum (NAF) and subsequent withdrawal by NAF from consumer arbitration.
 - July 2009 Congressional hearing on use of mandatory arbitration in debt collection cases.
 - Franken amendment to Defense appropriations bill.

Legislative proposals (cont'd)

- Two pending financial services reform bills would authorize federal agencies to “prohibit or impose conditions or limitations on” pre-dispute arbitration:
 - Consumer Financial Protection Agency Act of 2009 (H.R. 3126): gives such authority to the CFPB, with respect to agreements between consumers and financial services providers.
 - Investor Protection Act of 2009 (H.R. 3817): amends the Securities Exchange Act of 1934 and the Investment Advisers Act of 1940 to give such authority to the SEC with respect to consumer agreements.

Conclusions

1. Notwithstanding the standard in *AT&T* (questions of arbitrability are “undeniably” for the court to decide), there has been an inexorable shift in U.S. case law towards “letting the arbitrator decide” arbitrability questions, including the issue of whether an arbitration clause is unconscionable.

Conclusions (cont'd)

2. This shift in approach, while promoting consistency in arbitration law, also eliminates an important check on one-sided arbitration agreements.
 - An approach that generally defers to the arbitrator's power to determine her jurisdiction, while adopting special safeguards for consumer and employment arbitration, finds support in the practice of other countries (such as France).

Conclusions (cont'd)

3. The *First Options* standard either should be overruled or narrowly construed.
 - Enforcing a standard form agreement to “let the arbitrator decide” her jurisdiction, without full judicial review of such decision, is particularly troubling in the mandatory arbitration context, where the agreement itself – the very source of the arbitrator’s authority – is being challenged as unconscionable.