Insight

IN-DEPTH DISCUSSION

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High Court Again Finds a California Court Failed to Place Arbitration Agreements on Equal Footing With Other Contracts

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On December 14, 2015, in *DirecTV, Inc. v. Imburgia*, the U.S. Supreme Court reversed a California State Court of Appeal decision that had invalidated an arbitration provision based on language from the agreement rendering the entire arbitration provision unenforceable if the "law of your state" makes class-arbitration waivers unenforceable. The Supreme Court found that the California court's interpretation of the phrase "law of your state" was unique to arbitration contracts and violated the requirement of the Federal Arbitration Act (FAA) that arbitration contracts be placed on equal footing with other contracts. As a result, the California Court of Appeal's interpretation was preempted by the FAA. While not arising from an employment law case, this shows that the Supreme Court will not necessarily accept a state court's claim that generally applicable principles of contract law preclude enforcement of an agreement governed by the FAA. Instead, the High Court will scrutinize the state court's rationale to see whether arbitration agreements are disproportionately affected by the application of the state rule.

Facts and Procedural History

DIRECTV, Inc. ("DIRECTV"), entered into service agreements with its customers that contained a mutual agreement to arbitrate claims. The mandatory arbitration provision, expressly governed by the FAA, contains a class arbitration waiver, but also provides "[i]f . . . the law of your state would find this agreement to dispense with class arbitration procedures unenforceable, then this entire [arbitration provision] is unenforceable." Despite the arbitration provision, two customers brought suit in California state court seeking damages for early termination fees they claimed violated California state law. DIRECTV sought to enforce the arbitration provision, but the trial court denied the request and DIRECTV appealed.

The California Court of Appeal analyzed whether the law of California makes the class-arbitration waiver unenforceable and therefore renders the entire arbitration provision unenforceable. Although the Court of Appeal acknowledged that the California Discover Bank[1] rule – which rendered class-arbitration waivers in consumer contracts unenforceable – was preempted by the

1 See *Discover Bank v. Superior Court*, 36 Cal. 4th 148, 162 (Cal. 2005).

FAA in *AT&T Mobility LLC v. Concepcion ("Concepcion")*, 563 U.S. 333, 352 (2011), it nevertheless found the class-arbitration waiver was unenforceable under California state law. The Court of Appeal reasoned that by using the phrase "law of your state," the parties were referring to California law without regard to preemption by the FAA. This was because: (1) "the law of your state" provision was paramount to the more general provision invoking the FAA; and (2) because the company had drafted the language, any ambiguity should be construed against the drafter. The California Supreme Court denied discretionary review, and the U.S. Supreme Court granted DIRECTV's petition for writ of certiorari.

The U.S. Supreme Court's Analysis

Justice Breyer, who wrote the majority opinion,[2] recognized the Court's analysis must focus on whether the California Court of Appeal's decision placed arbitration contracts on equal footing with other contracts and, more specifically, whether the decision was based on "grounds as exist at law or in equity for the revocation of any contract" – the standard required by Section 2 of the FAA. The majority found the California Court of Appeal's interpretation would not apply to contracts other than arbitration agreements and was therefore not a valid ground to refuse to enforce the provision.

In concluding that the Court of Appeal's interpretation was unique to arbitration contracts and did not place arbitration contracts on equal footing with other contracts, the Supreme Court found the contract was not ambiguous. Rather, the Court determined that the phrase "the law of your state" could only mean "valid state law" and neither party, nor the dissent, cited any case from California or elsewhere interpreting similar language to apply to an invalid state law. Next, although at the time the parties entered into the contracts at issue the Discover Bank rule was still valid, the Court noted that, under California's general contract principles, references to "California law" should incorporate changes in the law retroactively. As a result, the Supreme Court concluded that the "law of your state" language should be interpreted in light of the Discover Bank rule's subsequent invalidation by Concepcion.

The Supreme Court further pointed out that nothing in the Court of Appeal's decision suggests that a California court would interpret the "law of your state" language the same way in any other context, other than in regards to an arbitration agreement, or that a California court would interpret the language to include state laws preempted by federal law. Instead, the Court of Appeal's opinion focused only on arbitration.

The Court also disagreed with the Court of Appeal's conclusion that the Discover Bank rule maintained legal force, despite being invalidated by *Concepcion*. As Justice Breyer wrote, "[t]he view that state law retains independent force even after it has been authoritatively invalidated by [the U.S. Supreme Court] is one courts are unlikely to accept as a general matter and to apply in other contexts."

Lastly, the Court found that the Court of Appeal's argument that the "law of your state" language was paramount to the more general provision adopting the FAA, simply begs the question how to interpret the words "the law of your state."

The Supreme Court therefore concluded the California court's analysis did not place arbitration contracts on equal footing with all other contracts, and thus failed to give "due regard … to the federal policy favoring arbitration." Accordingly, the Court of Appeal's interpretation was preempted by the FAA and reversed.

Conclusion

This latest pro-arbitration decision from the U.S. Supreme Court is significant for several reasons. As an initial matter, it is interesting that the majority opinion – which interprets "the law of your state" language in light of *Concepcion* – is authored by Justice Breyer and joined by Justice Kagan, both of whom dissented in *Concepcion*. The Court is more unified in its position here in relation to the FAA's preemptive effect over state law contract defenses that purport to apply to contracts generally.

2 Justices Roberts, Scalia, Kennedy, Alito, and Kagan joined in the majority opinion. Justice Thomas filed a dissenting opinion. Justice Ginsburg filed a dissenting opinion, in which Justice Sotomayor joined.

Second, it is evident by the decision that the Court will heavily scrutinize opinions that purport to rely upon the FAA's "Savings Clause"[3] to invalidate arbitration agreements. Lower courts may not simply pay lip-service to treating arbitration agreements like any other contracts. To the contrary, a court must engage in a sincere analysis establishing that it is placing arbitration contracts on equal footing with other contracts.

Finally, it appears from the Court's opinion that parties seeking to invalidate arbitration agreements under the Savings Clause, and overcome the federal policy favoring arbitration agreements, must be prepared to show that the grounds for nullifying an arbitration contract would apply the same way in other contexts.

3 Section 2 of the FAA states, in part, that agreements to arbitrate "shall be valid, irrevocable, and enforceable, save upon such grounds as exist at law or in equity for the revocation of any contract."