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Phone: +1 646 783 7100 | Fax: +1 646 783 7161 | customerservice@law360.com

Struggle At The Supreme Court Over Arbitration Clauses

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James M. Schurz

The U.S. Supreme Court returned to familiar territory last week in DirecTV Inc. v. Imburgia (argued Oct. 6, 2015): the enforceability of an arbitration clause in a consumer contract containing a class action waiver.

But this time there was a wrinkle. Arbitration proponents, who can cite a string of recent victories in this area, encountered a Supreme Court struggling with the proper role of federal courts in policing a state court's refusal to send a consumer class action to arbitration based on state contract law principles.

Here's what's at stake: Amy Imburgia filed a class action in Los Angeles Superior Court in 2008 against DirecTV, alleging false advertising and unfair competition claims stemming from DirecTV's early termination fees assessed against Imburgia because she canceled her account early. DirecTV moved to compel arbitration, pointing to the class action waiver and the choice of law provision calling for application of the Federal Arbitration Act. So far this follows the pattern of cases the Supreme Court has consistently held must go to individualized arbitration since its landmark decision AT&T Mobility Inc. v. Concepcion, 131 S. Ct. 1740 (2011).

Here's where things are different: The DirecTV customer contract included a poison pill provision — if "the law of your state would find the agreement to dispense with class arbitration procedures unenforceable, then [the entire arbitration clause] is unenforceable." The trial court denied the motion to compel, finding the class action waiver was unenforceable under California's Private Attorney General Act of 2004, and, therefore the whole arbitration clause fails.

The California court of appeal affirmed but for different reasons. The court of appeal concluded that the reference to "the law of your state" in the DirecTV contract encompassed both existing state laws as well as state laws that were preempted by federal law. Specifically, the California court concluded that "the law of your state" included the California rule barring class action waivers that the Supreme Court concluded was preempted in Concepcion.

The Ninth Circuit in a parallel case characterized the state appellate court's reasoning as "nonsensical." On this issue there was agreement among the justices. Justice Elena Kagan observed that the state court probably got it wrong, then corrected herself: "Strike the 'probably.'"

But the problem is: What is a federal court supposed to do about it? Justice Stephen Breyer cautioned against federal courts becoming "supervisors" of state court judges' interpretations of contracts. Justice Kagan observed that even though the California court got it wrong, "wrongness is just not what we do here." She was joined by Justice Anthony Kennedy who questioned: "How can we reverse the determination if it's a matter of state law interpreting a contract made by two people?" Justice Samuel Alito joined the chorus asking: "Does that mean whenever there is a dispute about the scope of an arbitration clause and a state court says that it includes a certain subject or doesn't," it becomes a question of federal law?

The answer is yes. And it has been a question of federal law since Volt Information Sciences Inc. v. Stanford University, 489 U.S. 468 (1989). In 1983, the Supreme Court in Moses H. Cone v. Mercury Construction Corp. declared that the Federal Arbitration Act "create[s] a body of federal substantive law of arbitrability." This substantive body of federal arbitration law the court explained in Volt "establish[es] that, in applying general state law principles of contract interpretation to the interpretation of an arbitration agreement [ ], due regard must be given to the federal policy favoring arbitration, and ambiguities as to the scope of the arbitration clause itself resolved in favor of arbitration."

What troubles a number of the justices in Imburgia is that to make operational the Volt test may open the federal courts to a tidal wave of cases. Counsel for Imburgia sought to capitalize on this uneasiness; he closed by stating: "Not everything is a federal case."

True enough, but the question of whether a state court applied state law contract interpretation principles in a manner consistent with the federal policy favoring arbitration has been an issue for federal courts since 1989. As a result, interpreting and enforcing an arbitration agreement governed by the Federal Arbitration Act is a hybrid of state and federal law. Federal law is used as a check to ensure that the agreement to arbitrate is interpreted in a manner consistent with the federal substantive law of arbitrability. Chief among these requirements is the rule that courts must "rigorously enforce arbitration agreements according to their terms." American Express Co. v. Italian Colors Restaurant, 133 S. Ct. 2304 (2013).

Lower courts have applied the Supreme Court's Volt test in a wide range of cases — whether the problem is the construction of the contract language itself or an allegation of waiver, delay or other defense to arbitrability. It has been a burden on the federal courts — one that is part of a larger group of cases brought to enforce the federal policy favoring arbitration that is at the core of the Federal Arbitration Act.

The Supreme Court is unlikely to depart from the Volt standard or limit its application. The California Court of Appeal's ruling frustrates, rather than enforces, the parties' written arbitration agreement — precisely what the Federal Arbitration Act prohibits. Viewed in this context, DirecTV v. Imburgia is fundamentally about the supremacy of federal law. Lower courts "must abide by the FAA, which is the 'supreme Law of the Land.'" Nitro Lift Techs. LLC v. Howard, 133 S. Ct. 500, 503 (2012). Because "[s]tate courts rather than federal courts are most frequently called upon to apply the [FAA], … [i]t is a matter of great importance … that state … courts adhere to" their obligations under that federal statute. Id. at 501. Justice Breyer is reluctant to "supervise" state court judges' application of state contract interpretation principles. But federal courts have been engaged in this exercise under the Federal Arbitration Act since at least 1989. Despite the justices' concerns about the proper limits of the federal courts' reach in evaluating the application of state contract interpretation principles, it is likely that this court will rule in favor of DirecTV.

—By James M. Schurz, Morrison & Foerster LLP

James Schurz is a partner in Morrison & Foerster's San Francisco office.

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