# RECENT UPDATES FROM THE WORLD OF ARBITRATION:

# TEXAS AND BEYOND

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# ARBITRATION UPDATE: TEXAS AND BEYOND

## I.

## Arbitration in Texas: Now More Appealing?

The state of Texas has long been noted for its swashbuckling, independent nature. We see this demonstrated in pronouncements from the state's elected representatives from time-to-time, usually on a subject that evokes a fresh debate about state's rights and the intrusion of the Federal Government into the daily lives of its citizens.

Now, the Judicial Branch of the state, through its highest court, has stoked the debate anew. In *Nafta Traders Inc. v. Quinn*, 339 S.W.3d 84 (Tex. 2011) (*Nafta)* the Texas Supreme Court dove head first into the "Federal Supremacy" pool through the unlikely subject of arbitration. This paper will examine just how far-reaching this decision might be, particularly when juxtaposed with decades of decisions that expanded rather than contracted the prominence of the Federal Arbitration Act (FAA). 9 U.S.C. §1. *Nafta* represents a significant departure from a long-standing trend.

On the other hand, on the national front, the U.S. Supreme Court did its part to continue the FAA's expansion in *AT&T Mobility LLC v. Concepcion,* 563 U.S. __, 131 S.Ct. 1740, 179 L.Ed.2d 742 (2011), when it reasserted FAA preemptions over California judicial and statutory jurisprudence. Both of these opinions, as will be seen, are notable for both their departure from established case authority and, conversely, for their upholding the sanctity of private contracts.

## II.

## The *Nafta* Decision

In *Nafta,* (Justice Hecht writing for the majority) the petitioner, an international redistributor of athletic apparel and foot wear, had terminated the employment of the respondent Quinn. Quinn brought suit alleging sex discrimination, whereupon Nafta invoked an arbitration provision in the company's employee handbook. The trial court entered an agreed order sending the case to arbitration before a single arbitrator appointed by the American Arbitration Association. The arbitration provision in the employee handbook did not specify whether state or federal law would apply, although the parties apparently treated the case as if the Texas General Arbitration Act (TAA) governed the proceedings. *See* Tex. Civ. Prac. & Rem. Code §171.001.

The arbitration hearing resulted in an award for Quinn, consisting of back pay, mental anguish, "special damages" and attorney's fees and costs totaling approximately $200,000.00. Nafta moved for vacatur under the FAA, TAA, the common law and the provision in the arbitration portion of the handbook that read:

> "The arbitrator does not have the authority (i) to render a decision which contains a reversible error of state or federal law, or (ii) to apply a cause of action or remedy not expressly provided for under existing state or federal law."

*Nafta Traders*, 339 S.W.3d at 91. Nafta asserted that by agreeing to the limits on the arbitrator's authority, by logical extension the parties had agreed to alter the scope of judicial review otherwise provided under either the FAA or the TAA.

Quinn, for her part, argued that the grounds asserted by Nafta for vacatur were not among those in either the FAA or TAA, and that the employee handbook provision was too vague to permit the reading urged by Nafta. After all, the U. S. Supreme Court had ruled the

appeal grounds in FAA section 10 were exclusively limited to instances of arbitrator misconduct rather than arbitrator error or mistake, and that parties may not contractually expand either the grounds or nature of judicial review. *Hall Street Associates, L. L. C. v Mattel, Inc.*, 552 U.S. 576, 578 (2008). But after Quinn succeeded in the trial court and on appeal, the Texas Supreme Court granted Nafta's Petition for Review.

The court reversed and held that the "**TAA** presents no impediment to an agreement that limits the authority of an arbitrator in deciding a matter **and thus allows for a judicial review of an arbitration award for reversible error**." *Nafta Traders*, 339 S.W.3d at 97. (emphasis added) In so holding, the court departed from well-established authority that for years had consistently guarded against an erosion of FAA predominance. In fact, much of Justice Hecht's opinion involved an in-depth analysis (and distinction) of the Supreme Court's *Hall Street Associates* ruling that the FAA's grounds for vacatur and modification are exclusive and cannot be "supplemented by contract." *Id*. at 91-96.

In an interesting passage in the opinion, Justice Hecht set the stage for distinguishing *Nafta* from the *Hall Street* opinion:

> "We must, of course, follow *Hall Street* in applying the FAA, but in construing the TAA, we are obligated to examine *Hall Street's* reasoning and reach our own judgment."

*Id.* at 92.

Simply put, this presages what some have viewed and will view as an endorsement of Texas' "state's rights" advocacy. The lengthy *Nafta* opinion would have the reader believe that the TAA remains harmonious with the FAA, given long-standing case authority ruling that state arbitration acts are preempted by the FAA if they are found to be inconsistent with that Act. But since the FAA provides (per *Hall Street*) that the grounds for vacatur or modification under the

FAA listed therein are "exclusive", how then can the *Nafta* opinion be harmonized, if indeed it can be? A review of case authority that inexorably expanded the FAA's reach demonstrates how remarkable a departure from that trend the *Nafta* decision is.

**III.**

**The Rise of Federal Preemption**

The FAA was enacted in 1925 at the urging of merchants seeking congressional help to overcome or offset judicial hostility to arbitration agreements. S. Goldberg, *et al.* DISPUTE RESOLUTION: NEGOTIATION, MEDIATION AND OTHER PROCESSES (5th ed. 2007). Merchants were seeking an efficient, cost-effective means of resolving disputes, and arbitration had offered those advantages (at least theoretically) since the 13th century. Congress first enacted the FAA as procedural law, applicable only to Federal Courts due to its recognition of Congress' limited power under the Commerce Clause. Thus, in *Erie Railroad Company v. Tompkins,* 304 U.S. 64 (1938), the Supreme Court held that in diversity cases, a Federal Court should apply federal procedural law, but must apply state substantive law in determining parties' rights. So long as courts continued to view the FAA as federal procedural law, *Erie* was not an impediment to its enforcement.

However, in *Bernhardt v. Polygraphic Co. of America,* 350 U.S. 198 (1956), the Supreme Court held that the duty to arbitrate did indeed involve substantial law. Thus, in diversity cases, state laws regarding arbitration rather than federal governed. In that case, the Court applied Vermont law to deny a request for arbitration.

Eleven years later, in *Prima Paint Corp. v. Flood & Conklin Mfg. Co.,* 388 U.S. 395 (1967), the Supreme Court, relying on the Commerce Clause, held that Congress did have the power to issue rules governing federal court procedures for resolving disputes, including the

enforceability of arbitration clauses, regardless of whether such rules were procedural or substantive. Left open was the question of the extent to which Congress could impose such rules on state courts.

It was in 1984, in *Southland Corp. v. Keating,* 465 U.S. 1 (1984) that the Supreme Court addressed the issue of federal supremacy in the area. In that opinion Chief Justice Burger stated:

> "In enacting section 2 of the [FAA], Congress declared a national policy favoring arbitration and withdrew the power of the states to require a judicial forum for the resolution of claims which the contracting parties agreed to resolve by arbitration . . ."

465 U.S. at 10. Thus, as long as the arbitration provision was part of a written maritime contract or a contract "evidencing a transaction involving commerce" such provision was enforceable as with any other contract.

Interestingly, the Court relied upon the *Prima Paint* case as one of the building blocks upon which to construct its conclusion that the FAA was both procedural and substantive, and thus applied with equal force to state as well as federal courts. The final observation of the majority opinion summarized the Court's recognition of expansive federal authority:

> "In creating a substantive rule applicable in state as well as federal courts, Congress intended to foreclose state legislative attempts to undercut the enforceability of arbitration agreements."

465 U.S. at 16. The Court then proceeded to declare that the California franchise investment law, which limited the availability of arbitration, violated the Supremacy Clause of the United States Constitution.

The *Keating* decision has been followed numerous times, permitting the Supreme Court to reiterate that state law, to the extent that it "undermines" the enforceability of an arbitration agreement and not other contracts, is preempted by the FAA. *See, e.g. Doctor's Associates,*

*Inc. v. Casarotto,* 517 U.S. 681 (1996) (invalidating state law requiring "larger print" for consumer contract provisions waiving right to sue in court); *Allied – Bruce Terminix Co. v. Dobson,* 513 U.S. 265 (1995) (prohibited state courts from using specific performance to enforce arbitration agreements). These decisions, like others, found state laws that treated arbitration provisions different than other contracts to be unsustainable.

A full understanding of *Nafta* requires mention of *Volt Information Services, Inc. v. Bd of Trustees of the Leland Stanford Jr. Univ,* 489 U.S. 468 (1989), a case the Texas court readily discussed in the *Nafta* opinion. In *Volt,* the parties had entered into a construction agreement containing an arbitration provision. Additionally, the contract contained a choice of law provision (California law). When a dispute between the parties arose, Volt demanded arbitration. In response, Stanford filed suit against Volt and two other contractors, then moved to stay the arbitration under California law which permitted a stay of arbitration pending resolution of related litigation between a party to the arbitration agreement and a third party non-signatory. In a somewhat surprising opinion, the Supreme Court enforced the California law even though it required staying the arbitration until the California court proceeding had concluded. 489 U.S. at 468. The Court noted that parties are free to agree to the application of a particular state's laws so long as those laws were consistent with the FAA. *Id.* at 479 (permitting courts to "rigorously enforce" agreements according to their terms does not do "violence to the policies behind the FAA."). In *Volt,* there was no such inconsistency seen; rather, the Court viewed the California code provision as procedural, and as a statute that did not fly in the face of the FAA's objectives.

The *Hall Street* decision, cited *supra,* followed the trend developed in the aforementioned cases. In transfiguring the FAA from a procedural act addressed only to federal

courts, to one that preempted state law, both substantively and procedurally, *Hall Street* made the next logical leap in finding that the FAA provided grounds for appeal that were exclusive, grounds which could not be modified by a parties' agreement. This, of course, is precisely contrary to what the *Nafta* decision accomplished.

## IV

## What will be *Nafta's* Impact?

Since arbitration must start with an agreement providing for a dispute being resolved through that process, we must first look to the transactional side to determine the impact of the *Nafta* decision. Because of its recency, any reliance predictions cannot be made with confidence. Anecdotally, however, transactional lawyers and their clients are seeking guidance from those experienced in arbitration as to the meaning and effect of *Nafta.* Much like decisions within our state which upheld jury waivers, the inclusion of arbitration provisions that expand appellate rights beyond those provided in the FAA, TAA or other arbitration acts are being viewed with greater favor.

And why not? Notwithstanding the ebb and flow of the popularity of arbitration, as supporters and detractors point out theoretical advantages versus real life experiences (theoretical: expedited proceeding with lower costs; real life: can be as protracted and expensive as court litigation), this latest opinion, at least where choice of law provisions dictate Texas law application, will empower clever lawyers to craft provisions that allow appeal rights equivalent to those available to traditional litigants. When contracts with such provisions are tested, we will only then begin to appreciate the practical limits – and real effect – of the *Nafta* case.

## V.

## Class Action Waivers Find New Life

While the *Nafta* decision was reverberating through legal channels in Texas, the U.S. Supreme Court was reaffirming the preemptive supremacy of the FAA. In *AT&T Mobility LLC v. Concepcion,* 563 U.S. __, 131 S.Ct. 1740 (2011) (*Concepcion*) the high court reversed the Ninth Circuit's affirmance of the district court's denial of AT&T's motion to compel arbitration. In doing so, it overturned a seemingly well-established rule announced by the California Supreme Court in *Discover Bank v. Superior Court,* 36 Cal. 4th 148, 113 P.3d 1100 (2005). In *Discover Bank,* the California Supreme Court had found that an arbitration provision that contained a class action waiver in a consumer agreement to be unconscionable under CAL. CIV. CODE ANN. §1668 because (1) the agreement was in an adhesion contract, (2) the dispute between the parties was likely to involve small amounts of damages, and (3) the party with inferior bargaining power alleged a deliberate scheme to defraud. *Concepcion,* 563 U.S. at __, 131 S.Ct. at 1746 (describing the *Discover Bank* rule as one "classifying most collective-arbitration waivers in consumer contracts as unconscionable").

In *Concepcion,* the cellular telephone contract between AT&T and the Plaintiffs required arbitration of all disputes but prohibited class wide arbitration. When the Concepcions were charged sales tax on the retail value of phones provided free under their service contract, they brought suit in U.S. District Court in California. Their case was consolidated with a class action alleging that AT&T had engaged in false advertising and fraud by charging such sales tax on free phones. The district court, later affirmed by the Ninth Circuit, denied AT&T's motion to compel arbitration, finding the arbitration provision to be unconscionable because it disallowed class wide proceedings. Both courts based their decisions on the *Discover Bank* holding.

The Ninth Circuit found that the FAA did not preempt California law in light of the exception found in FAA § 2, wherein arbitration agreements are deemed to be "valid, irrevocable and enforceable **save upon such grounds as exist at law or in equity for the revocation of any contract.**" *Laster v. AT&T Mobility LLC*, 584 F.3d 849, 857 (9th Cir. 2009) (quoting 9 U.S.C. § 2 and finding *Discover Bank* rule was simply "a refinement of the unconscionability analysis applicable to contracts generally in California") (emphasis added).

In the 5-to-4 decision (Scalia, J., writing for the majority) the Supreme Court rejected the Concepcions' claim that the *Discover Bank* rule was a valid FAA § 2 exception as a basis that "exists at law or in equity for the revocation of any contract." The Court observed, in discussing the *Discovery Bank* rule,

> "when state law prohibits outright the arbitration of a particular type of claim, the analysis is straightforward: The conflicting rule is displaced by the FAA. *Preston v. Ferrer,* 552 U.S. 346, 353 (2008). But the inquiry becomes more complex when a doctrine normally thought to be generally applicable, such as duress or, as relevant here, unconscionability, is alleged to have been applied in a fashion that disfavors arbitration."

*Concepcion,* 563 U.S. at __, 131 S.Ct. at 1747. The Court offered examples to illustrate this rule: State laws classifying as unconscionable or unenforceable as against public-policy consumer arbitration agreements that "fail to provide for judicially monitored discovery," "fail to abide by Federal Rules of Evidence, or disallow an ultimate disposition by a jury." 563 U.S. at __, 131 S.Ct. at 1747. Despite any reasoning that these illustrative rules would be designed to address the general principle of unconscionability, and thus not offend FAA § 2, "in practice … the rules would have a disproportionate impact on arbitration agreements…."

Of considerable interest is the majority's portrayal of the offending *Discover Bank* rule as not "requiring" the availability of class-wide arbitration, but rather "allow[ing] any party to a consumer contract to demand it *ex post*." 563 U.S. at __, 131 S.Ct. at 1750. Here, the

Supreme Court reached back to the Opinion from its prior term that held imposing class arbitrations on parties who had not agreed specifically to that procedure was inconsistent with the FAA. *Id*. at 1750 (citing *Stolt-Nielsen S.A. v. AnimalFeeds Int'l Corp*., 559 U.S. __, 130 S.Ct. 1758, 1773-76 (2010)). In that case, an arbitration panel had exceeded its powers by imposing its own policy choice of class arbitration into a commercial maritime contract that was silent about the class procedure. That contractual silence meant the arbitration panel and later, the Second Circuit, could not compel a party "to submit to class arbitration unless there [was] a contractual basis for concluding the party agreed to do so." *Stolt-Nielsen*, 559 U.S. at __, 130 S.Ct. at 1775. Changes brought about by the shift from bilateral to class arbitration are "fundamental," including (1) absent parties, which necessitated additional and different procedures, (2) higher stakes, and (3) difficulty maintaining confidentiality. *Concepcion,* 563 U.S. at __, 131 S.Ct. at 1750 (quoting *Stolt-Nielsen*).

From this, the Supreme Court majority concluded that class arbitration could be considered to be manufactured by *Discover Bank,* rather than consensual, and hence, rendering it further inconsistent with the FAA. It is the enforcement of agreements entered into by parties that the Court found to be a fundamental building block of the FAA. Given, then, that the FAA was designed to promote arbitration, and given the further finding that the *Discover Bank* rule hinders that objective, the Court concluded that the California Supreme Court's three-part rule is preempted by the FAA, necessitating the reversal and remand of the case.

Finally, in perhaps a further rationalization within its holding the Court *in dicta* (majority opinion) observed that the arbitration provision in question was fair and that "aggrieved customers who filed claims would be 'essentially guarantee[d]' to be made whole." 563 U.S. at __, 131 S.Ct. at 1753 (quoting the circuit court—*Laster*, 584 F.3d at 856, n. 9).

## VI.

## Beyond *Concepcion*

The influence of *Concepcion* was immediate. On the day the Supreme Court announced its Opinion, it also granted writ of certiorari, vacated, and remanded three other decisions. *See Sonic Automotive v. Watts*, 563 U.S. __, 131 S.Ct. 2872 (2011) remanded to South Carolina Supreme Court); *Litman v. Cellco P'ship*, 563 U.S. __, 131 S.Ct. 2873 (2011) (remanded to third circuit); *Missouri Title Loans, Inc. v. Brewer*, 563 U.S. __, 131 S.Ct. 2875 (2011) (remanded to Missouri Supreme Court). In August following the remand, the Third Circuit reversed itself and affirmed, post-*Concepcion*, the district court's dismissal of a class action the circuit court initially had reversed pre-*Concepcion.* *See Litman v. Cellco P'ship*, __ F.3d __, 2011 U.S. App. Lexis 17649, No. 08-4103 (3rd Cir. August 24, 2011), *on remand from, Cellco P'ship v. Litman,* 131 S.Ct. 2872 (2011) (table), *vacating and remanding*, *Litman v. Cellco P'ship,* 381 F. App'x 140 (3d Cir. 2010). In its 2010 unpublished ruling the court had upheld as not inconsistent with the FAA New Jersey state law—*Muhammad v. Cnty Bank of Rehoboth Beach,* 912 A.2d 88, 100 (N.J. 2006)—which had pronounced class action waivers unenforceable because they discouraged individual claimants from pursuing small damages amounts and, thus, were functionally exculpatory. To the extent there was any doubt following *Concepcion*, *Cellco Partnership* makes clear that state law hostility to a class waiver in an arbitration agreement itself faces an equally hostile review. Neither the Missouri nor South Carolina Supreme Courts have yet ruled.

Perhaps as far reaching will be decisions addressing class action arbitration waivers in employee contracts and representative-standing granted to individuals under state private attorney general acts. Questions involving both are currently proceeding through district courts.

*Compare Quevedo v. Macy's, Inc.*, __F. Supp 2d __, 2011 WL 3135052 (C.D. Cal. June 16, 2011) (California's Private Attorney General Act permitting claimant to pursue claims individually and in representative capacity cannot override employee's representative-capacity arbitration waiver) (currently on motion for reconsideration); *with Sutherland v. Ernst & Young*, 768 F. Supp 2d 547 (S.D.N.Y. 2011) (class action waiver in employee arbitration agreement held unenforceable because it precluded employee from vindicating state and federal law rights) (currently on motion for reconsideration).

The Supreme Court will again consider the reach of the FAA during its current term when it announces an opinion in *Compucredit Corp v. Greenwood*, No. 10-948 (U.S. Jan 25, 2011) (argued Oct. 11, 2011). Before the Court is the question whether a federally nonwaivable "right to sue," as used in the Credit Repair Organization Act, 15 U.S.C. § 1679 (2006) (CROA), precludes enforcement of the consumer's predispute agreement to arbitrate. The Ninth Circuit concluded that CROA's references to a non-waivable "right to sue" made unenforceable a company's arbitration agreement with its customers. *Greenwood v. Compucredit Corp*, 615 F.3d 1204, 1214 (9th Cir. 2010), *cert*. *granted* (CROA §1679f(a) precludes enforcement of any waiver of "any protection provided by or any right of the consumer under this subchapter . . . ."). The Supreme Court will have the final say on the Ninth Circuit's opinion that "the plain and ordinary" meaning of "sue" precludes arbitration. *See id.* at 1208-09.

In short, state law statutes or judicial rulings that interfere with the FAA's "over-arching purpose" to ensure enforcement of arbitration agreements will face continued scrubbing, regardless of whether the state law procedure or substantive right "is desirable for unrelated reasons." *Concepcion*, 563 U.S. at __, 131 S.Ct. at 1753. Manufactured class or representative-capacity arbitration, rather than consensual agreement between parties, is

inconsistent with the FAA. General principle unconscionability or public-policy disapproval of exculpatory agreements, especially those arising in an employment and consumer context, and which apply only to arbitration, derive their meaning from the fact that an agreement to arbitrate is at issue, or have a "disproportionate impact" on arbitration agreements are most likely to fail. *Id.* at 746-47.

## Conclusion

In a curious but extremely important way, both the *Nafta* and *Concepcion* opinions – the one finding against FAA preemption, the other finding in favor thereof – have similar outcomes. Both uphold private agreements in accordance with the parties' intent. If the reader is to take anything away from these two landmark decisions, it is that the highest courts in Texas and in the United States will seemingly go to great lengths to give parties what they bargained for in those agreements. To be sure, we should anticipate an increase in the popularity of arbitration provisions, tailored to individual negotiations, in a commercial setting.