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The Supreme Court Examines Whether Courts Must Decide the Enforceability of Arbitration Clauses Challenged as Unconscionable

April 28, 2010

The Supreme Court heard oral arguments on April 26 in *Rent-A-Center West, Inc. v. Jackson*, No. 09-497, a case in which the Court is expected to decide whether, under the Federal Arbitration Act ("FAA"), a court and not an arbitrator must determine the validity of an agreement to arbitrate that is challenged as unenforceable. Specifically, the Court will review whether lower courts must resolve claims that arbitration clauses are unconscionable even where the arbitration clauses themselves delegate to arbitrators the exclusive authority to resolve disputes as to the enforceability of such clauses.

Federal and state courts are divided on the question of when, under the FAA, courts may in the first instance determine the validity of an arbitration clause. For instance, the Ninth Circuit held in this case that a court must first determine whether an arbitration provision is unconscionable under state law, even when the issue is delegated to an arbitrator under the terms of the arbitration agreement. By contrast, the Eighth and Eleventh Circuits have held that, under the default rule, courts must decide challenges to arbitration agreements, but parties may contract around this rule by clearly and unmistakably vesting the arbitrator with that authority. *See Terminix Int'l Co. v. Palmer Ranch Ltd. P'ship*, 432 F.3d 1327 (11th Cir. 2005); *Bailey v. Ameriquest Mortgage Co.*, 346 F.3d 821 (8th Cir. 2003). The First Circuit generally adheres to the same rule as the Eighth and Eleventh Circuits, but carves out an exception allowing courts to strike arbitration clauses when the arbitral remedy is illusory. *See Awuah v. Coverall N. America, Inc.*, 554 F.3d 7 (1st Cir. 2009). The Federal Circuit took yet another approach, limiting courts' inquiries to whether the party's assertion of arbitrability is "wholly groundless." *Qualcomm Inc. v. Nokia Corp.*, 466 F.3d 1366 (Fed. Cir. 2006). The Court here is poised to resolve this split among the circuits regarding who in the first instance must decide challenges to enforceability based upon unconscionability.

BACKGROUND

Rent-A-Center arose from a dispute between Antonio Jackson and his employer, Rent-A-Center West, Inc. ("RAC"). In February 2003, Jackson and RAC entered into an arbitration agreement covering disputes arising from Jackson's employment relationship with RAC. The arbitration agreement provided that "[t]he Arbitrator, and not any federal, state, or local court or agency, shall have exclusive authority to resolve any dispute relating to the interpretation, applicability, enforceability or formation of this Agreement including, but not limited to any claim that all or any part of this Agreement is void or voidable." *Jackson v. Rent-A-Center West, Inc.*, 581 F.3d 912, 914 (9th Cir. 2009).

The Report From Washington is published by the Washington, D.C. office of Simpson Thacher & Bartlett LLP.

In 2007, Jackson sued RAC in the United States District Court for the District of Nevada pursuant to 42 U.S.C. § 1981. Jackson alleged that RAC first failed to promote him based on his race, and then promoted him but fired him within two months of that promotion in retaliation for Jackson's pre-promotion complaints that he had not been promoted as a result of his race.

RAC moved to compel arbitration pursuant to the terms of the arbitration agreement, arguing that the FAA required arbitration of Jackson's claims of race discrimination and retaliation. RAC relied specifically on Section 2 of the FAA, which provides that "an agreement in writing to submit to arbitration an existing controversy arising out of such a contract, transaction, or refusal, shall be valid, irrevocable, and enforceable, save upon such grounds as exist at law or in equity for the revocation of any contract."

Jackson conceded that he signed the arbitration agreement, but argued that the agreement was unenforceable based on the doctrine of unconscionability. Jackson claimed the arbitration agreement was procedurally unconscionable because he was in an unequal bargaining position and was presented the form contract as a non-negotiable condition of employment. Jackson also claimed the agreement was substantively unconscionable because: (1) it required arbitration of claims commonly brought by employees, but not claims commonly brought by employers; (2) it placed limits on discovery, which was to RAC's advantage given that Jackson had the burden of proof; and (3) it split the cost of the arbitration equally between the parties.

Granting RAC's motion to compel arbitration, the district court held that the arbitration agreement clearly and unmistakably vested the arbitrator with the exclusive authority to decide the enforceability of the arbitration agreement. Without reaching the other issues Jackson raised, the district court nevertheless found that the cost sharing provision of the arbitration agreement was not substantively unconscionable.

On appeal, the United States Court of Appeals for the Ninth Circuit upheld the district court's finding that the cost sharing provision was not unconscionable, but reversed and remanded the case to the district court to evaluate Jackson's additional unconscionability claims. The Ninth Circuit based its decision on the principle that "arbitration is a matter of contract and a party cannot be required to submit to arbitration any dispute which he has not agreed so to submit." 581 F.3d at 917 (internal quotes omitted). Interpreting Supreme Court precedent, the Ninth Circuit found that, while courts are presumed to determine in the first instance whether parties agreed to arbitrate, parties may overcome this presumption with clear and unmistakable evidence of intent to vest this power with the arbitrator. The Ninth Circuit reasoned, however, that the ability of parties to overcome this presumption with clear contractual language does not definitely resolve whether such language is itself enforceable. Instead, the Ninth Circuit held that courts must apply ordinary state law principles to determine whether the parties agreed to arbitrate in the first instance. The threshold question of whether an arbitration agreement is unconscionable, therefore, must be answered by the court. Because the district court had not examined all of Jackson's unconscionability claims, the Ninth Circuit remanded the case.

On January 15, 2010, the Court granted RAC's petition for writ of certiorari.

SUMMARY OF THE ARGUMENT

At oral argument on April 26, the employer RAC repeatedly stressed that Section 4 of the FAA only allowed courts to examine issues that go to the "making" of agreements to arbitrate. RAC maintained that unconscionability is a post-formation issue, and thus arbitrators may decide such challenges to arbitration clauses.

The Justices first explored what should be considered the "making" of an arbitration agreement under Section 4. Justices Ginsburg and Kennedy questioned, if fraud in the inducement of an arbitration clause is a formation issue exclusively decided by courts, why unconscionability should not be treated the same. In response to RAC's position that procedural unconscionability does not involve the making of a contract, Justice Scalia wondered whether "you could argue that on its face the agreement is so one-sided, so unconscionable, that one of the parties must have been coerced into signing it."

RAC then argued courts may conduct only a limited inquiry to determine two issues: (1) whether there are no issues with the making of the contract; and (2) whether the arbitral remedy is not rendered illusory because the arbitration terms prohibit access to the arbitrator. Justice Sotomayor questioned whether RAC's position is unwieldy given that courts would have to determine whether an unconscionability attack went to the making of the contract because it was akin to coercion, or if instead it was a post-formation issue. In response, RAC stated that fairness is always a post-formation issue.

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JUSTICE BREYER

Chief Justice Roberts asked whether a party could claim that "the provisions are so one-sided that you may assume from that that the formation was not voluntary." Justice Scalia then questioned whether, even though evidence of one-sidedness is not sufficient, it could not be used in combination with other evidence to show there was no agreement in the first place. Justice Breyer asked: "why as a general matter of contract law [is] an allegation of unconscionability . . . not enough like the coercion defense or the inducement defense . . . that they should be treated alike?" RAC answered that unconscionability does not rise to the same level as fraud or coercion.

Jackson relied on Section 2 of the FAA, arguing that it requires courts to leave the door open for challenges under state contract law defenses, including unconscionability.

Justice Sotomayor and Chief Justice Roberts questioned whether Jackson claimed that the entire arbitration agreement was unconscionable, or just certain terms of the agreement. According to Chief Justice Roberts, "once you get past that [g]ateway question of whether the formation of the contract was not unconscionable, then claims that particular provisions were unconscionable are by definition for the arbitrator to decide." Jackson later clarified that he was arguing that the provisions of the arbitration agreement render the entire agreement unconscionable.

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CHIEF JUSTICE ROBERTS

Justice Scalia asked why an arbitrator could not decide unconscionability given that they need only apply state law, noting: "if [the arbitrator] has totally disregarded all State law regarding unconscionability, wouldn't . . . you have a basis to set aside . . . the arbitration?" Jackson initially relied on Section 2 of the FAA, but when pressed argued that the provisions in the FAA for judicial review of arbitration decisions were inadequate given the great deference they are afforded.

Justice Breyer asked if Jackson was arguing that courts must decide whether individual provisions of otherwise enforceable arbitration agreements are invalid, and expressed doubt that such a position was tenable: "if you concede that there is a valid arbitration

"[I]f you concede that there is a valid arbitration agreement . . . and you are arguing over the scope of different provisions or whether certain provisions within it are valid or invalid, why can't you submit that to an arbitrator."

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agreement between you and your client, and you are arguing over the scope of different provisions or whether certain provisions within it are valid or invalid, why can't you submit that to an arbitrator if it is clear enough?" Justice Kennedy further questioned: "how can [Jackson] prevail in this case if the agreement clearly comprehends submission of this issue to the arbitrator?" After Jackson again fell back on Section 2 of the FAA, claiming that the doors to the court must always remain open, Justice Ginsburg observed that Section 2 does not say who decides state law grounds for revocation of contract.

After Jackson, in response to a question from Justice Ginsburg, indicated that all adhesion contracts would be subject to unconscionability challenges under Section 2, Justice Scalia observed that there is "[n]ot much use signing an arbitration agreement then, not much for the employer, he is going to end up in court anyway, every one of them will be thought of as unconscionable . . . ." Jackson countered that courts could quickly dispose of baseless unconscionability challenges.

On rebuttal, the RAC reiterated that that there are only two issues for courts: (1) whether or not there is an issue with the making of the agreement; and (2) whether or not there is access to arbitration.

IMPLICATIONS

In deciding this case, the Court is expected to resolve the question of whether a claim that an arbitration clause is unconscionable must be decided by a court even when the arbitration clause clearly and unmistakably delegates questions of enforceability to the arbitrator. If the Court holds that lower courts must rule on claims of unconscionability under such circumstances, the Court would make it easier for plaintiffs to ask courts to second guess the enforceability of such arbitration agreements, particularly in the context of employment, consumer protection, and other areas in which there may be claims of unequal bargaining power between contracting parties. Critics of this approach argue that courts have surreptitiously used claims of unconscionability to channel judicial hostility against the use of arbitration, contrary to the public policy in favor of arbitration. On the other hand, if the Court were to prevent lower courts from ruling on unconscionability when the arbitration clause delegates that issue to the arbitrator, critics argue, this would limit protections against being forced into arbitration to which parties allegedy had never meaningfully agreed.

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