Can State Law Render Arbitration Agreements Unenforceable?

Related Lawyers: Walter D. Kelley Jr.

Related Practice Areas: Antitrust / Competition

Section 2 of the Federal Arbitration Act generally overrides any state statute or common law doctrine that attempts to undercut the enforceability of an arbitration agreement. However, Section 2 contains a savings clause that permits invalidation of an arbitration agreement “upon such grounds as exist at law or in equity for the revocation of any other contract.”[1] Thus, arbitration agreements may be invalidated by “generally applicable contract defenses, such as fraud, duress or unconscionability.”[2]

Can generally applicable contract defenses defeat an arbitration provision where they are facially neutral but have a disparate impact on the use of ADR? In its May 2017 decision in *Kindred Nursing Centers, L.P. v. Clark*,[3] the United States Supreme Court answered this question in the negative. The contracts at issue were powers of attorney (“POA”) that prospective residents of a nursing home were required to sign. The POAs granted the named attorneys-in-fact general power over the residents’ affairs, including the power to sign all contracts. The attorneys-in-fact in *Clark* used this power to sign the nursing home’s standard admission contract, which included a mandatory arbitration provision. When the residents who granted the POAs later sued the nursing home for substandard care, the nursing home moved to dismiss on the ground that arbitration was the only permissible forum for the residents’ claims. The trial court denied the motion and the Kentucky Supreme Court affirmed.

The Kentucky Supreme Court initially framed the case as one involving a contract defense known as the clear statement rule. This rule, which had not previously been recognized, provides that “the power to waive fundamental constitutional rights must be unambiguously expressed in the text of the power-of-attorney document in order for that authority to be vested in the attorney-in-fact.”[4] For example, an attorney-in-fact could not—without express authorization—agree to contracts that “waive the principal’s civil rights; or the principal’s right to worship freely; put her child up for adoption; consent to abort a pregnancy; consent to an arranged marriage; or bind the principal to personal servitude.”[5] The Kentucky Supreme Court then held that the state constitutional right to a civil jury trial was a similarly fundamental liberty, calling it “inviolate,” “sacred,” and a “divine God-given right.”[6]
Despite the United States Supreme Court's stark divisions in other cases involving the FAA, it reversed by a vote of 7-1. (Justice Thomas dissented based on his longstanding view that the FAA does not apply to proceedings in state courts). While acknowledging that Section 2's savings clause allows courts to invalidate arbitration provisions based on traditional state contract defenses, the Court reaffirmed the longstanding corollary that such defenses must not be applied in a manner that disadvantages arbitration. The Court in *Clark* denounced the Kentucky Supreme Court's so-called clear statement rule as "too tailor made to arbitration agreements—subjecting them, by virtue of their defining trait, to uncommon barriers."[7]

As detailed in my prior articles on arbitration,[8] many state courts and legislatures have been unabashed in their hostility to the United States Supreme Court's arbitration jurisprudence. The resistance has not gone unnoticed. In the oral argument that preceded the Supreme Court's 2016's arbitration opinion in *Direct TV v. Imburqia*,[9] Justice Breyer mused at length about the problems the Justices face when lower courts intentionally flout unpopular lines of cases, such as the Court's arbitration decisions. Indeed, during the oral argument in *Clark*, Justice Breyer stated "What I really think has happened is that Kentucky just doesn't like the Federal law. That's what I suspect. So they're not going to follow it."[10]

The Kentucky Supreme Court made itself an easy target in *Clark*. By characterizing the state's guarantee of civil jury trials as a right grounded in both natural and divine law, the Kentucky Supreme Court unmasked its intent to circumvent federal precedent. Bland language describing unremarkable principles of state contract law would have given the plaintiffs a far better chance when the appeal went up to the U.S. Supreme Court.

Fortunately, common law contract law principles are not the only state law basis upon which to challenge an arbitration provision. The Supreme Court has long held that arbitration is also inappropriate when it entails a loss of substantive common law or statutory rights. A May 2017 Fourth Circuit decision shows how effective this line of attack can be.

The bank defendant in *Dillion v. BMO Harris Bank*[11] was accused in a class action of violating RICO by facilitating illegal payday loans. The loans were actually originated by a lender owned by an Indian tribe. Before funding the payday loans, the trial lender required prospective borrowers to sign a contract that not only specified arbitration, but also declared that tribal law would exclusively govern the parties' relationship, and that "no other state or federal law or regulation shall apply to this Agreement, its enforcement or interpretation."[12] The bank tried to use this arbitration/choice of law provision to block adjudication of the class action in federal court.

The Fourth Circuit held that the choice of law clause was an unenforceable prospective waiver of the plaintiff's right to pursue statutory remedies. Rather than severing the offending clause, the court instead struck the entire arbitration agreement. The court concluded that the arbitration and choice of law provisions were an integrated scheme "to avoid federal and state consumer protection law."[13]

*Dillion* involved an extreme example. Most companies are shrewder than to openly exclude the application of substantive statutory protections. More seasoned companies seek to accomplish the same goal indirectly by restricting the procedures a plaintiff may use rather than restricting the causes of action he or she can assert. For example, companies are permitted to require that their customers waive the right to assert class or collective actions, even in arbitration. The companies know that one-off claims—particularly in consumer litigation—are rarely financially viable.

Not surprisingly, California has led the fight against overreaching arbitration provisions. Judicial efforts to declare such provisions unconscionable have almost uniformly failed,[14] but the California legislature may have found a way to level the playing field.

The California Private Attorneys General Act of 2004 ("PAGA")[15] authorizes an employee to bring an action for civil penalties on behalf of the state for violations of certain labor statutes. The real party in interest is significant because arbitration provisions are not enforceable against a state. In essence, PAGA is a type of *qui tam* action under which penalties can be imposed for violations committed against persons other than the plaintiff.
California has two statutes that render unenforceable pre-dispute agreements to waive representative PAGA claims. In *Sakkab v. Luxottica Retail North America, Inc.*, the Ninth Circuit recently relied on those statutes to hold that a waiver of representative PAGA claims contained in an arbitration provision was void as against public policy. In doing so, it followed the California Supreme Court's 2014 decision in *Iskanian v. CLS Transportation of Los Angeles, LLC.* Both courts held that the FAA did not preempt the California non-waiver statutes because they placed arbitration agreements on equal footing with non-arbitration agreements. In other words, PAGA waivers are prohibited in court as well as in arbitration, so the assertion of PAGA claims in arbitration do not, as a practical matter, interfere with conduct of those proceedings.

In April 2017, the California Supreme Court extended its *Iskanian* reasoning to cover statutory remedies. California's Consumer Legal Remedies Act, its unfair competition law, and its false advertising law each expressly provide for public injunctive relief. In *McGill v. Citibank, N.A.*, the California Supreme Court refused to enforce, and declared invalid, an arbitration provision that purported to waive the plaintiff's statutory rights to seek public injunctive relief. The court held that the waiver violated California public policy because it would compromise the public purpose that the injunction statutes were intended to serve. Another California statute expressly provides that "a law established for a public reason cannot be contravened by private agreement."[19]

Especially interesting was the California Supreme Court's discussion in *McGill* of the fact that the waiver was included in an arbitration provision. The court rejected the defendant's claim that this placement somehow immunized a waiver that otherwise would be unenforceable in court. The *McGill* court quoted the United States Supreme Court's admonition that "by agreeing to arbitrate a statutory claim, a party does not forgo the substantive rights afforded by the statute; it only submits to their resolution in an arbitral, rather than judicial, forum."[20] Then, in a nice piece of judicial jujitsu, the California Supreme Court used the defendant's overreaching to throw it back into the California state court system that it had sought to avoid. In response to defendant's protestation that it had contracted to avoid injunction claims in arbitration, the Supreme Court severed plaintiff's claim for injunctive relief and ruled that it would be addressed in court after liability and damages had been arbitrated.

**Conclusion**

The FAA does not pre-empt state law; it merely prohibits a state from treating arbitration agreements less favorably than other contracts. Counsel faced with an unwelcome Motion to Compel Arbitration should: (i) review the arbitration provision in context to see if it displaces the client's substantive statutory or common law rights; (ii) check for state statutes, such as PAGA, that might provide complete relief in a different way; and, (iii) review the formation and terms of the arbitration agreement for compliance with the state's common law contract principles. The opinions discussed in this article are only recent examples of the case law in each category. Much more extensive authority exists. If used properly, state law can be a powerful weapon in the arsenal of a litigator who wants to try his or her case in a courtroom rather than a conference room.

**Footnotes**


[5] *Extendicare*, 478 S.W. 3d at 328


[9] 136 S. Ct. 463 (2015)(Imburqia held that the FAA overrides California law prohibiting enforcement of a binding arbitration provision with a class action waiver.)


[12] Id. at 332

[13] Id. at 336


[16] 803 F.3d 425 (9th Cir. 2015)

[17] 327 P.3d 129 (Cal. 2014)

[18] 393 P.3d 85 (Cal. 2017)


*Walter D. Kelley, Jr. is a partner in the Washington, D.C. office and a former United States District Judge for the Eastern District of Virginia.