

No. _____

IN THE SUPREME COURT OF CALIFORNIA

DISCOVER BANK,

Petitioner,

v.

THE SUPERIOR COURT OF LOS ANGELES COUNTY,

Respondent;

CHRISTOPHER BOEHR,

Real Party in Interest.

After an Order by the Court of Appeal, Second Appellate District, Case No. B161305, Granting Petition for a Writ of Mandate from the Order of the Superior Court of Los Angeles County, Case No. BC256167, Granting a Motion for Reconsideration, The Honorable Carolyn Kuhl

PETITION FOR REVIEW

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STATEMENT OF ISSUES

1. Is a provision in a non-negotiable arbitration clause in a consumer contract involving small sums of money per consumer but millions of dollars in the aggregate, that prohibits consumers from bringing or participating in a class action, conscionable and enforceable as a matter of California contract law? (No.)
2. If a type of provision in an adhesion contract is unconscionable under the California law of contracts that is generally applicable to all contracts, does the Federal Arbitration Act preempt this California contract law if such a provision is included in a contract that also contains an arbitration clause? (No.)

STATEMENT OF THE CASE

Plaintiff Christopher Boehr obtained a credit card from defendant Discover Bank in 1986. In July of 1999, Discover unilaterally added an arbitration clause to the cardholder agreements of its customers. The clause states, in part:

NEITHER YOU NOR WE SHALL BE ENTITLED TO JOIN OR CONSOLIDATE CLAIMS IN ARBITRATION BY OR AGAINST OTHER CARD MEMBERS WITH RESPECT TO OTHER ACCOUNTS, OR ARBITRATE ANY CLAIM AS A REPRESENTATIVE OR MEMBER OF A CLASS OR IN A PRIVATE ATTORNEY GENERAL CAPACITY.

On August 15, 2001, plaintiff Christopher Boehr filed this putative class action. The complaint alleged that Discover improperly failed to credit customer payments on the day received, resulting in improper late fees and interest charges being assessed against its cardholders. Plaintiff believes that the claims of most individual putative class members are well below \$100, and many are under \$1.00, although they amount to million of dollars in the aggregate.

The trial court initially granted Discover's motion to compel arbitration. The trial court noted that Discover's unilateral amendment would not form a binding contract under California law. Nonetheless, the trial court held that Delaware law governed the issue of contract formation and that a contract was formed under Delaware law.¹ The trial court rejected the plaintiff's challenge to the prohibition on class actions, stating that "[t]here does not appear to be a California appellate authority holding that a contract clause precluding one party from bringing a class action is unconscionable." Accordingly, the trial court compelled plaintiff to arbitrate his case on an individual basis.

Shortly after that order was entered, the Fourth District Court of Appeal issued its decision in *Szetela v. Discover Bank* (2002) 97 Cal.App. 4th 1094 ("*Szetela*"), holding that Discover's use of an adhesive arbitration clause to prohibit class actions was unconscionable. After considering the *Szetela* decision, the trial court reversed its previous ruling and held that the provision barring class actions was unconscionable and unenforceable. The trial court did not strike the entire arbitration clause, however. Instead, the trial court severed the class action ban from the rest of the arbitration clause, and compelled plaintiff to arbitrate his claims.

Discover chose not to trust the possibility of class-wide arbitration of this case before the arbitration firm it selected, however. Instead, Discover appealed the trial court's order to the Court of Appeals for the Second District. That Court of Appeals issued its opinion on January 14, 2003. The opinion reverses the trial court's order striking the class action ban, and requires plaintiff to pursue his claims on an individual basis.

¹ Plaintiff disagrees with the Court of Appeals' reasoning on this point, but does not pursue that question in this Petition in an effort to narrow the issues.

The Court of Appeals' opinion below recognizes that the FAA "places arbitration agreements on an equal footing with contracts generally." 105 Cal. App.4th 326, 328. The Court below also noted that another California Court of Appeals had refused to enforce a choice of law provision that was not contained in an arbitration clause that barred California consumers with small claims from proceeding on a class action basis. 105 Cal. App.4th at 340, citing *America Online, Inc. v. Superior Court* (2001) 90 Cal.App. 4th 1 ("AOL"). The court below nonetheless stated that *AOL* did not apply here because that case did not involve an arbitration agreement or the FAA. 2003 WL 116143 at * 8. The court below thus concluded that, whatever California law might be for outright bans on class actions in contracts in general, the FAA preempted the application of such state law when such bans appeared in arbitration clauses.

The Court of Appeals recognized that the primary purpose of the FAA "was to reverse the longstanding judicial hostility to arbitration agreements. . . ." 105 Cal. App. 4th at 332 (citation omitted). The Court then proceeded to prohibit the possibility that the plaintiffs' class-wide claims could be arbitrated because of its concerns that "a multi-million dollar class arbitration award entered on nothing more than mere whim cannot be corrected under California law." *Id.* at 348. With this hostile view of the arbitration process in mind, the court below concluded that "we disagree with the *Szetela* decision and grant Discover Bank's petition." *Id.* at 331. The Court of Appeals held that the FAA "preempts a state court's ability to invalidate on state substantive law grounds the express terms of a validly formed arbitration agreement. . . ." *Id.*

REASONS FOR GRANTING THE PETITION

Summary of Argument

Prior to the decision below, the law was clear in California that a provision in an adhesion contract barring consumers or other individuals with little bargaining power from bringing their claims on a class action basis was unconscionable and unenforceable. As this Court explained in *Keating v. Superior Court*, (1982) 31 Cal.3d 584, *rev'd on other grounds sub nom., Southland Corp. v. Keating* (1984) 465 U.S. 1, contractual provisions banning class actions “effectively foreclos[e] many individual claims,” and thus “may well be oppressive and may defeat the expectations of the nondrafting party.” *Keating*, 31 Cal.3d at 608. This rule has been applied in a series of cases by California Courts of Appeal to strike down prohibitions on class actions in contracts containing arbitration clauses, *see, e.g., Szetela*, 97 Cal.App. 4th at 1100-01, and *Mandel v. Household Bank (Nevada)* (2003) 105 Cal. App. 4th 75 (applying Nevada law), and in contracts that do not contain arbitration clauses. *See AOL*, 90 Cal.App. 4th at 8. A number of federal courts applying California law have followed *Keating* and *Szetela* and have applied this rule to bans on class actions included in arbitration clauses. *See Ting v. AT&T* (N.D. Cal. 2002) 182 F. Supp.2d 902, 918, *aff'd with respect to unconscionability ruling*, (9th Cir. February 11, 2003) 2003 WL 292296; *ACORN v. Household Int'l, Inc.* (N.D. Cal. 2002) 211 F. Supp.2d 1160, 1173; *Comb v. Paypal, Inc.* (N.D. Cal. 2002) 218 F. Supp.2d 1165. The decision below has greatly muddled this previously clear law, however, and creates a chaotic situation where neither consumers nor lenders can predict the legal effect of contract terms banning class actions in a contract also containing an arbitration clause.

The Court of Appeals' decision in this case has not only created confusion and discord in the law of this state, but it is very much in error.

The Court below held that California's generally applicable law of unconscionability is preempted by the FAA whenever that law strikes down "the express terms of a validly formed arbitration agreement." 2003 WL 116143 at * 1. This absolutist conclusion is wrong for two reasons.

First, § 2 of the FAA provides that courts should not enforce arbitration clauses that run afoul of generally applicable state contract law, such as California's proscription of unconscionable contract terms. As *AOL* demonstrates, California law generally does not permit contractual bans of class actions in adhesive contracts, as such bans would apply to persons with small claims. The Court of Appeals' position is that even if a contractual ban on class actions is illegal under California law that is generally applicable to all contracts, the FAA requires that such a ban nonetheless be enforced if it is included in an arbitration clause. As the FAA itself and the U.S. Supreme Court have made clear, the FAA incorporates – rather than sweeps away – such generally applicable state laws. The absolutist reasoning of the Court below is also flatly contrary to several rulings of this Court and many other courts that arbitration clauses whose "express terms" are particularly unfairly and one-sided are unconscionable and thus unenforceable. *E.g.*, *Armendariz v. Foundation Health Psychare Serv.s, Inc.* (2000) 24 Cal. 4th 83 (striking down as unconscionable an arbitration clause whose "express terms" were one-sided and imposed excessive costs on an employee); *Graham v. Scissor-Tail, Inc.* (1981) 28 Cal. 3d 807 (striking down as unconscionable an arbitration clause whose "express terms" rendered the arbitrator presumptively biased in favor of one party).

Secondly, the U.S. Supreme Court has instructed that under the FAA, arbitration clauses are only enforceable to the extent that they permit parties to effectively enforce their statutory rights. Here, the plaintiffs'

claims are so small that the vast majority of persons will not be able to vindicate those claims on an individual basis (whether in court or in arbitration). Furthermore, the prohibition on class action litigation in this case functions as an effective deterrent to litigating many types of claims involving fees, penalties, and interest and, ultimately, serves to shield Discover from liability even in cases where it has violated the law. Accordingly, prohibiting this arbitration clause banning class actions is entirely consistent with the FAA.

ARGUMENT

I. THE DECISION BELOW IS FLATLY WRONG.

A. DISCOVER'S CONTRACT TERMS CANNOT BE ENFORCED IF THEY ARE UNCONSCIONABLE UNDER CALIFORNIA LAW.

Discover has argued that it does not matter whether its contract is unconscionable under California law, because the contract provides that it is governed by Delaware law. Discover's premise is that Delaware law is so favorable to banks that it would find almost nothing unconscionable.²

² In fact, Delaware courts – like this Court – have struck down abusive and excessively unfair arbitration clauses as unconscionable. *Worldwide Inc. Group v. Klopp* (Del. 1992) 603 A.2d 788. Nonetheless, Delaware law of unconscionability is much less mature and developed than California law, and Delaware is unclear as to the conscionability of contract provisions banning class actions in contracts of adhesion. There is one Delaware lower court decision stating that a contractual ban on class actions is not unconscionable, but that decision offers no explanation and is purely conclusory. The Court of Appeals relied upon one federal case that did not involve state law unconscionability issues, or the application of the FAA to such law, but instead addressed questions of interpretation of federal statute not involved here. *Johnson v. W. Suburban Bank* (3d Cir. 2000) 225 F.3d 366, *cert. denied*, 531 U.S. 1145 (2001), cited by the Court below at 105 Cal. App. 4th at 334. The *Johnson* case revolved around the language and legislative history of the Truth in Lending Act. That case says nothing about what Delaware or California state law may

(continued...)

If this premise is correct, then California law is clear that the choice-of-law clause may not be enforced. As this Court stated in *Washington Mutual Bank v. Superior Court* (2001) 24 Cal.4th 906, “Of course, choice-of-law agreements have no effect in a class action if the trial court determines that they are unenforceable. . . .” 24 Cal.4th at 918. This Court went on to state:

The weaker party to an adhesion contract may seek to avoid enforcement of a choice-of-law provision therein by establishing that “substantial injustice” would result from its enforcement . . . or that superior power was unfairly used in imposing the contract.

Id. The Court held that if a forum selection clause contravenes a fundamental California policy, it will not be enforced. *Id.* at 917. *See also AOL*, 90 Cal. App. 4th at 12 (“California courts will refuse to defer to the selected forum if to do so would substantially diminish the rights of California residents in a way that violates our state’s public policy.”). *AOL* held that if a forum selection clause limits the substantive legal rights of California consumers, the agreement will not be enforced. *See id.* at 12 (“Our law favors forum selection agreements only so long as . . . California consumers will not find their substantial legal rights significantly impaired by their enforcement.”), and at 13 (forum selection clause will not be given effect if this would “result in an evasion of a . . . statute of the forum protecting its citizens.”). Accordingly, Discover cannot avoid California’s law of unconscionability by pointing to Delaware law. If this Court holds that Discover’s Arbitration clause is unenforceable under California law, then this Court should never reach Delaware law.

B. UNDER GENERALLY APPLICABLE CALIFORNIA

² (...continued)
or may not be with respect to exculpatory clauses.

CONTRACT LAW, A PROVISION IN A CONTRACT OF ADHESION THAT PROHIBITS CLASS ACTIONS IS UNCONSCIONABLE.

While the court below temporizes on the subject, it is beyond doubt that Discover's ban on class actions would have been unconscionable under generally applicable California contract law if it were not incorporated into an arbitration agreement. Once this conclusion is established, then the only question becomes whether the court below is correct that the FAA then overrides this contract law simply because the provision is incorporated into an arbitration agreement.

Under generally applicable California contract law, unconscionability has both a "procedural" and a "substantive" element. Both the procedural and substantive elements must be present before a court will hold that a contract is unenforceable, but they need not be present to the same degree. *See Armendariz*, 24 Cal.4th at 114. Instead, there is a "sliding scale relationship between the two concepts: the greater the degree of substantive unconscionability, the less the degree of procedural unconscionability that is required to annul the contract or clause," and vice versa. *Id.*

There is no question here that Discover's arbitration clause is procedurally unconscionable. Under California law, if a contract is one of adhesion, it is procedurally unconscionable. *Circuit City v. Adams* (9th Cir.) 279 F.3d 889, 893, *cert. denied*, (2002) 122 S. Ct. 2329 (a contract is procedurally unconscionable if it is "a contract of adhesion: a standard-form contract, drafted by the party with superior bargaining power, which relegates to the other party the option of either adhering to its terms without modification or rejecting the contract entirely."); *Flores v. Transamerica Homefirst, Inc.* 93 Cal.App. 4th 846, 853 (same); *Mercuro v. Superior*

Court (2002) 96 Cal.App. 4th 167, 174 (same). In this case, it is undisputed that Discover's arbitration clause was a standard form contract unilaterally promulgated on a take-it-or-leave-it adhesive basis.

As this Court has previously instructed, a contractual ban on class actions is substantively unconscionable as applied to persons with individually modest claims. In *Keating*, for example, this Court held that clauses banning class actions "may well be oppressive and may defeat the expectations of the nondrafting party." *Keating*, 31 Cal.3d at 608. This Court went on to say that "[i]f the right to a classwide proceeding could be automatically eliminated in relationships governed by adhesion contracts through the inclusion of a provision for arbitration, the potential . . . for chilling the effective protection of interests common to a group[] would be substantial." *Id.* at 609.

In *AOL*, the Court of Appeals applied this same rule to a contract that did not involve an arbitration clause, but instead involved a forum-selection and choice-of-law clause requiring litigation in Virginia, whose procedural rules do not permit class actions:

"A class action by consumers produces several salutary byproducts, including a therapeutic effect upon those sellers who indulge in fraudulent practices. . . ."

The unavailability of class action relief in this context is sufficient in and by itself to preclude enforcement of the TOS forum selection clause.

AOL, 90 Cal.App. 4th at 17-18, quoting from *Vasquez v. Superior Court* (1971) 4 Cal.3d 800, 808.

The *AOL* decision arose from a generally-applicable California public policy favoring class-wide relief as an important facet of consumer protection. This Court has held that "class actions offer consumers a means of recovery for most individual damages. . . ." *Linder v. Thrifty Oil Co.*

(2000) 23 Cal.4th 429, 445 (case not involving an arbitration clause). Under this generally applicable California law, it is recognized that if consumers with small claims are barred from pursuing class litigation, they will likely be denied any meaningful remedy for most wrongs that the company might commit against them. In short, “defendants should not profit from their wrongdoing simply because their conduct harmed large numbers of people in small amounts instead of small numbers of people in large amounts.” *Id.* at 446 (internal quote, citation omitted).

This generally applicable law is what animated the Court of Appeals in *Szetela*. In that case, the Court correctly explained that contractual prohibitions on class actions would effectively act as a “get out of jail free” card for corporate defendants:

It is the manner of arbitration, specifically, prohibiting class or representative actions, we take exception to here. The clause is not only harsh and unfair to Discover customers who might be owed a relatively small sum of money, but it also serves as a disincentive for Discover to avoid the type of conduct that might lead to class action litigation in the first place. By imposing this clause on its customers, Discover has essentially granted itself a license to push the boundaries of good business practices to their furthest limits, fully aware that relatively few, if any, customers will seek legal remedies, and that any remedies obtained will only pertain to that single customer without collateral estoppel effect. . . . Therefore, the provisions violates fundamental notions of fairness.

Szetela, 96 Cal.App.4th at 1101.

One federal court applying California law and armed with a rich factual record expanded even further on this phenomenon. In *Ting*, the court found that without the class action mechanism, “the potential reward would be insufficient to motivate private counsel to assume the risks of prosecuting the case just for an individual on a contingency basis.” *Ting*, 182 F. Supp.2d at 918. Because of these economic realities, “the

prohibition on class action litigation functions as an effective deterrent to litigating many types of claims involving rates, services or billing practices and, ultimately, ...[serves] to shield AT&T from liability even in cases where it has violated the law.” *Ting*, 182 F. Supp.2d at 918. Accordingly, the *Ting* court found the ban on class actions in AT&T’s arbitration clause to be substantively unconscionable. *Id.* at 931.

According to the Court of Appeals below here, it does not matter whether Discover’s contractual ban on class actions would serve to shield the company where it has violated the law, or would eliminate any potential deterrent effect of the law on Discover, because federal law guarantees Discover’s right to so shield itself. In fact, the Court’s concern that Discover might face multi-million dollar liability in arbitration was one of the reasons it gave *supporting* the class action ban. As the next part of this brief establishes, the Court below is wrong on this point.

C. THE FEDERAL ARBITRATION ACT DOES NOT PREEMPT THE GENERALLY APPLICABLE PRINCIPLE OF CALIFORNIA STATE LAW HOLDING UNCONSCIONABLE BANS ON CLASS ACTIONS.

1. The FAA Does Not Preempt Generally Applicable State Contract Laws.

The Court below rejected *Szetela* on the grounds that the FAA supposedly sweeps away California’s law of unconscionability as it relates to any “express provision” of any arbitration contract, including any provision that bans class actions. This claim is simply incorrect.

The FAA has no express preemption provision and does not reflect a congressional intent to occupy the entire field of arbitration or contract law. *Volt Info. Sciences, Inc. v. Bd. of Trustees of Leland Stanford Junior Univ.* (1989) 489 U.S. 468, 477. Therefore, the FAA only preempts state laws

whose application would frustrate the will of Congress by undermining the Act's policy goals. *Id.* at 477-78. Since the FAA only preempts state laws that conflict with its underlying purposes, and since the FAA contains no provision regarding class actions, California law on this point cannot possibly be preempted. In the absence of significant conflict between federal policy and state law, state contract and consumer protection laws form an essential part of the framework for determining the rights, obligations, and remedies of the contracting parties.

In addition, the FAA incorporates a savings clause that provides that arbitration clauses will not be enforced if there are grounds under state contract law for invalidating the clause. 9 U.S.C. § 2. The U.S. Supreme Court has recognized that the defense of unconscionability is available to a party challenging an arbitration agreement. *Doctor's Assocs., Inc. v. Casarotto* (1996) 517 U.S. 681, 687 (“[G]enerally applicable contract defenses, such as fraud, duress or unconscionability, may be applied to invalidate arbitration agreements without contravening [the F.A.A.]”). In other words, state contract law applies to arbitration clauses. This principle is incorporated into the federal substantive law of arbitration. *Perry v. Thomas* (1987) 482 U.S. 483, 492-93 (“An agreement to arbitrate is . . . enforceable, *as a matter of federal law*, ‘save upon such grounds as exist at law or in equity for the revocation of any contract.’ . . . Thus state law, whether of legislative or judicial origin, is applicable if that law arose to cover issues concerning the validity, revocability, and enforceability of contracts generally.”) [emphasis in original, citations omitted]. Likewise, this Court has also recognized that a court may refuse to enforce *any* facially valid contract on the ground that it is unconscionable. *Armendariz*, 24 Cal. 4th at 114 (“Because unconscionability is a reason for refusing to enforce contracts generally, it is also a valid reason for refusing to enforce

an arbitration agreement.”).

Accordingly, the FAA does *not* preempt generally applicable state law contract doctrines. As set forth in Part I-B above, the rule of law applied in *Szetela* and rejected by the Court of Appeals below *is* a generally applicable rule of law. The rule that contracts of adhesion drafted by the party with superior economic power are procedurally unconscionable applies to all contracts, whether they include arbitration clauses or not. As the *AOL* case establishes, corporations may not write adhesive contracts to insulate themselves from legal responsibility if they break the law, whether those contracts involve arbitration or not. *AOL*, which is not an arbitration case, flows naturally from the reasoning of this Court’s decision in *Vasquez* and *Linder* (neither of which involved arbitration cases).

In reaching the conclusion that this generally applicable California contract law is preempted, the Court below adopted an approach that necessarily conflicts with that followed in numerous other decisions of California courts. The Court below asserts without reservation that the FAA “preempts a state court’s ability to invalidate on state substantive law grounds the express terms of a validly formed arbitration agreement. . . .” 105 Cal.App. 4th at 330. Under this approach, no express term of an arbitration agreement may ever be held to be unconscionable. Numerous California Courts have struck down part or all of “validly formed arbitration agreements” where some of their “express terms” violated California’s proscription against unconscionable contract terms. *See, e.g., Armendariz*, 24 Cal. 4th 83; *Graham*, 28 Cal.3d 807; *Mercurio v. Superior Court* (2002) 96 Cal.App. 4th 167 (where arbitration clause’s express terms required arbitration before a forum that was susceptible to repeat player bias, and clause required fee sharing by employees, it was unconscionable and unenforceable); *Flores* 93 Cal.App. 4th 846 (express terms of arbitration

clause that was non-mutual was unconscionable and unenforceable); *Pinedo v. Premium Tobacco, Inc.* (2000) 85 Cal.App. 4th 774 (express terms of arbitration clause requiring an employee to front all fees in arbitration was unconscionable and unenforceable); *Stirlen v. Supercuts, Inc.* (1997) 51 Cal.App. 4th 1519 (express terms of arbitration clause that were one-sided were unconscionable); *Patterson v. ITT Consumer Fin. Corp.* (1993) 14 Cal.App. 4th 1659 (where arbitration clause's express terms required arbitration in a prohibitively expensive forum, and in a forum that required consumers to travel to Minnesota to have their claims heard, the clause was unconscionable and unenforceable). If the logic and rationale of the Court of Appeals below were to be faithfully and consistently applied, it would be necessary to overturn each of these cases.

Numerous other courts have also rejected the claim that the FAA overrides state unconscionability law. In *Ting*, for example, the U.S. Court of Appeals for the Ninth Circuit has recently stated with respect to the ruling of the Court below, "We disagree with the California Court of Appeal's recent analysis in *Discover Bank v. Superior Court*. . . . We recognize, as does the court in *Discover Bank*, that the FAA preempts state laws of limited applicability, . . . but we follow well settled Supreme Court precedent in rejecting the proposition that unconscionability is one of those laws." *Ting v. AT&T*, (9th Cir. Feb. 11, 2003) 2003 WL 292296 at *22, n. 15. In *Ticknor v. Choice Hotels Int'l, Inc.* (9th Cir. 2001) 265 F.3d 931, similarly, although the defendant argued (as does the Court of Appeals in this case) that the FAA preempts state laws of unconscionability as they relate to arbitration clauses, the Ninth Circuit rejected that argument for reasons that apply here: "Montana law pertaining to the unconscionability of arbitration clauses was the result of 'the application of general principles that exist at law or in equity for the revocation of any contract.'" *Ticknor*,

265 F.3d at 941, citing *Iwen v. West Direct* (Mont. 1999) 977 P.2d 989, 996; see also *Circuit City v. Adams*, 279 F.3d 889, 895 (stating that California's law of unconscionability applies "to contracts generally and does not single out arbitration agreements for special scrutiny," and therefore "it is also a valid reason not to enforce an arbitration agreement under the FAA.").

The Court of Appeals decision itself contravenes the FAA by treating Discover's arbitration clause as different from other contracts. The FAA's goals are to "reverse the longstanding judicial hostility to arbitration agreements . . . and to place arbitration agreements *upon the same footing as other contracts.*" *Equal Employment Opportunity Comm'n v. Waffle House, Inc.* (2002) 534 U.S. 279, 289 (emphasis added, citation omitted).

Notwithstanding this law, the Court below did *not* put arbitration clauses on the same footing as other contracts. The Court of Appeals' position amounts to the following: even if California's general law of unconscionability would strike down exculpatory and one-sided terms in a contract not involving arbitration, that law is overridden by the FAA so long as such provisions are included in a section of a contract that *also* includes an arbitration provision. Nothing in the FAA permits parties to launder otherwise illegal contract terms and make them enforceable merely by sticking them under the heading of "arbitration," however, and this Court has never so held. As the West Virginia Supreme Court has held, the FAA does not allow for this kind of escape from state contract liability "merely because the prohibiting or limiting provisions are part of or tied to provisions in the contract relating to arbitration." *West Virginia ex rel. Dunlap v. Berger*, (W.Va. 2002) 567 S.E.2d 265, 280.

Finally, the argument of the lower court is circular. It states "We

hold that where a valid arbitration agreement governed by the FAA prohibits classwide arbitration, section 2 of the FAA preempts a state court from applying state substantive law to strike the class action waiver from the agreement." Note that the holding assumes a "valid arbitration agreement." However, the question of the validity of the arbitration agreement is the issue to be decided. The assumption that the arbitration agreement is itself valid is putting the cart before the horse.

2. The FAA Does Not Conflict With State Laws Prohibiting Arbitration that Do Not Permit Parties to Effectively Vindicate Their Substantive Rights.

The Court below further erred in finding FAA preemption in light of the fact that the U.S. Supreme Court has directed that arbitration clauses are enforceable under the FAA only if they make proceedings accessible so that claimants can effectively enforce their rights. *See, e.g., Gilmer v. Interstate/Johnson Lane Corp.* (1991) 500 U.S. 20, 26 (citation omitted) (“[B]y 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 a judicial, forum.”). As an illustration of this principle, the U.S. Supreme Court has recognized that “the existence of large arbitration costs may well preclude a litigant . . . from effectively vindicating [its] rights,” *Green Tree Financial Corp. v. Randolph* (2000) 531 U.S. 79, 81. The U.S. Supreme Court has stated that arbitration is acceptable as an alternative to litigation in court because it is simply a “different forum” – one with somewhat different and simplified rules, but nonetheless one in which the basic mechanisms for obtaining justice permit a party to “effectively vindicate” his or her rights. *See, e.g., EEOC v. Waffle House Corp.* 534 U.S. at 295 n. 10.

This principle explains why California law forbidding contract provisions that ban class actions is consistent with – rather than in conflict

with – the FAA. As the *Szetela* and *Ting* courts explained at some length, in a case such as this involving small sums, a contractual prohibition on class actions will prevent many consumers from “effectively vindicating” their statutory rights. Accordingly, state laws barring such provisions – such as the California law identified by this Court in *Keating* and by the Court of Appeals in *Szetela* – are entirely consistent with the FAA’s purposes, as those purposes have been recognized by the U.S. Supreme Court in cases such as *Gilmer* and *Randolph*.

3. The FAA Does Not Preempt California Law Relating to Contractual Bans On Class Actions, Because That Law Does Not Target or Prohibit Arbitration Agreements.

This case is not really about arbitration. If this Court reverses the decision of the Court of Appeals, Discover will still be able to hold its California customers to mandatory binding arbitration clauses if it so chooses. Indeed the trial court did not reject or deny arbitration, instead it ordered the plaintiffs to arbitrate their claims. If Discover wanted arbitration, it could have had it without bringing this appeal. The one thing that Discover could not have, however, whether in court or arbitration, was the ability to take away from customers the right to seek class-wide relief through class action proceedings (whether in arbitration or in court).

Notwithstanding the rhetoric of the Court below, applying the California rule prohibiting class action bans to contracts also providing for arbitration does not mean that corporations are barred from imposing arbitration on their consumers. No one denies that the drafter of any contract could both require arbitration *and* comply with *AOL*, merely by expressly providing that arbitrations could proceed on a class-wide basis. This fact alone demonstrates that state law prohibiting contractual bans on class actions does not violate the FAA.

The Court of Appeals below got sidetracked on an issue that is not necessary to decide this case – whether a contract that is *silent* on the subject of class actions permits class-wide arbitration. While this important issue is currently before the U.S. Supreme Court, *Bazzle v. Green Tree Fin. Corp.* (S.C.) 569 S.E.2d 349, *cert. granted* (2002) 123 S.Ct. 817, and while California state law has generally been favorable to class-wide arbitration when the contract is silent on this point, this issue is not dispositive here. The important point is that there is no conflict between the FAA and California law prohibiting contractual bans on class actions. There is no question that Discover could have forced its customers into arbitration *and* permitted class actions if it had wanted to do so. The question before the U.S. Supreme Court in *Bazzle* – whether a particular type of clause would have permitted class actions – does not change the central point.

Tellingly, however, the Court of Appeals’ discussion of this side issue reflects a mindset that is flatly antithetical to that of the FAA. As the court below recognized, the purpose of the FAA was to “reverse the longstanding judicial hostility to arbitration agreements. . . .” 105 Cal. App. 4th at 337 (citation omitted). Immediately after recognizing this principle, however, the Court of Appeals proceeded to violate it. The Court below relied upon gross hostility to arbitration to support its insistence that class actions must not be permitted in arbitration:

As judicial review of the merits of an arbitrator’s decision may not be had under California law, a multi-million dollar class arbitration award entered on nothing more than mere whim cannot be corrected under California law. Just as consumers may be harmed by the enforcement of an unconscionable class action waiver, defendant companies may be able to prove that they will be prejudiced if classwide arbitration is imposed where, even though the arbitration agreement is silent on the subject, the agreement has adopted arbitration rules, such as those of the AAA, that do not

provide for classwide arbitration.

105 Cal. App. 4th at 348. In other words, the Court of Appeals was concerned that arbitrators should not be permitted to handle important cases that might cost a corporate defendant a lot of money, because arbitrators might do a poor job (i.e., decide the case on “mere whim”) and because with arbitration generally, there is little judicial review available. This argument plainly demonstrates a hostility to arbitration.

Under this rationale, of course, arbitration should not be available for *any* important cases. Thus, if one began with the premise that denying justice to persons whose civil rights were violated or who had been cheated in violation of consumer protection statutes was as important as denying justice to a corporation defendant a class action, then following the rationale of the court below would necessarily lead to the conclusion that no mandatory arbitration could be allowed for individual consumer or employment cases either. The U.S. Supreme Court has flatly rejected this proposition, however. In *Gilmer*, the plaintiff argued that civil rights claims could not be forced into arbitration precisely because there was no meaningful judicial review of arbitrators’ decisions: 500 U.S. at 32 n.4. The Supreme Court rejected that argument, however, in its rejection of all arguments that represent a “generalized attack[] on arbitration.” *Id.* at 30.

II. A NUMBER OF OTHER STATE COURTS HAVE RECENTLY REJECTED THE POSITION OF THE COURT BELOW.

As the foregoing makes clear, the Court of Appeals’ decision in this case introduces an element of chaos into California law on an important and oft-repeating question. As a further indication of the importance of the issues raised in this Petition, two other state high courts have joined with *Szetela* in the last year in finding arbitration clauses that ban class actions to

be unconscionable, and thus unenforceable, under state law. The Alabama Supreme Court recently found a contract term banning class actions built into an arbitration clause to be unconscionable. *See Leonard v. Terminix Int'l Co.* (Ala. Oct. 18, 2002) 2002 WL 31341084 (petition for rehearing denied).³ The Court made a point of noting that such a ban affects rich and poor alike, as it forecloses *all* individual plaintiffs from bringing a claim where the expense of arbitrating is greater than the amount in controversy. “That the expenses of arbitration would exceed the amount in controversy is not a problem personal or peculiar to any particular consumer but is, rather, a phenomenon inherent in the transaction itself.” *Leonard*, 2002 WL 31341084 at *7. By “foreclosing the Leonards from an attempt to seek practical redress through a class action and restricting them to a disproportionately expensive individual arbitration,” the Court found that the defendants had essentially closed the door of justice to these consumers. *Id.* at *8. Thus, the arbitration clause was unconscionable.

Similarly, in *Dunlap*, 567 S.E.2d at 278, the West Virginia Supreme Court of Appeals held that an arbitration clause which effectively barred class actions under state law was unconscionable. “In Mr. Dunlap’s case, the total of \$8.46 in insurance charges that Friedman’s added to his purchase is precisely the sort of small-dollar/high volume (alleged) illegality that class action claims and remedies are effective at addressing.” The court went on to find that “[i]n many cases, the availability of class action relief is a *sine qua non* to permit the adequate vindication of consumer rights.” The court warned that “[t]hus, in the contracts of adhesion that are so commonly involved in consumer and employment

³ In *Leonard*, the arbitration clause was silent on whether the parties could pursue a class action, but the Court found such a remedy barred because class action arbitration is not possible in Alabama. *Leonard*, 2002 WL 31341084 at *5, n.2.

transactions, permitting the proponent of such a contract to include a provision that prevents an aggrieved party from pursuing class action relief would go a long way toward allowing those who commit illegal activity to go unpunished, undeterred, and unaccountable.” *Dunlap*, 567 S.E.2d. at 278-79.

The importance of this debate is underscored by the fact that *Teminix* and *Dunlap* represent only a fraction of the cases that have recently held that it is unconscionable for an arbitration clause to ban class actions. *See also Luna v. Household Finance Corp. III* (W.D. Wash., Nov. 4, 2002) 2002 WL 31487425, No. C02-1635L (“Here, the prohibition on class actions allows the Arbitration Rider to be ‘used as a sword to strike down access to justice instead of a shield against prohibitive costs.’ This finding weighs heavily in favor of a finding of substantive unconscionability.”) (citations omitted); *Powertel v. Bexley* (Fla.App. 1 Dist. 1999) 743 So. 2d 570, 576 (“By requiring arbitration of all claims, Powertel has precluded the possibility that a group of its customers might join together to seek relief that would be impractical for any of them to obtain alone.”); *Bailey v. Ameriquest Mortgage Co.* (D.Minn. Jan. 23, 2002) 2002 WL 100391, *7 (“[T]he inability to proceed collectively . . . has the effect of rendering plaintiff’s individual claims impractical to pursue. The right to proceed collectively is particularly critical to these plaintiffs, who, as previously mentioned, have relatively small individual claims.”); and *In re Knepp* (N.D. Ala. 1999) 229 B.R. 821, 827 (“If class actions are no longer an option, the vast majority of consumer claims involving relatively small sums of money on an individual basis will be left without a remedy.”).

These cases establish that the issues posed in this Petition are pressing ones confronting courts throughout the United States. This Court should resolve these issues for California, just as the high courts in

Alabama and West Virginia have resolved the issues in those states. These cases also establish that, notwithstanding a few federal courts that have rejected superficially similar arguments, there is widespread judicial approval of the principles enunciated by this Court in *Keating* and the Court of Appeals in *Szetela*, and rejected by the court below in this case.

CONCLUSION

For the foregoing reasons, this Court should grant the Petition for Review and reverse the Decision of the Court of Appeals.

Respectfully submitted,

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**CERTIFICATION REGARDING
LENGTH OF BRIEF**

I hereby certify that this brief contains 6546 words, including footnotes, as established by the word count of the computer program used for the preparation of this brief.

I declare and certify under the laws of the State of California that the foregoing statement is true and correct and that this certification was executed on February 20, 2003, in Oakland, California.

By:

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PROOF OF SERVICE BY MAIL

I, the undersigned, certify and declare that I am a citizen of the United States, over the age of 18 years, employed in the City of Oakland, County of Alameda, and not a party to this action. My business address is One Kaiser Plaza, Suite 275, Oakland, California, 94612.

I am readily familiar with Trial Lawyers for Public Justice's practice for collection and processing of documents for mailing with the United States Postal Service, being that the documents are deposited with the United States Postal Service with postage thereon fully prepaid the same day as the day of collection in the ordinary course of business.

On February 21, 2003, I served the within **Petition for Review** on the parties in this action listed below by placing a true copy thereof in a sealed envelope and depositing with the U.S. Postal Service, addressed as follows:

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I declare under penalty of perjury under the laws of the State of California that the foregoing is true and correct, and that this declaration was executed on February 21, 2003 at Oakland, California.

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**ATTACHMENT A:
OPINION FROM COURT OF APPEALS**