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The state of play

SUCCESSFUL CHALLENGES TO ARBITRATION CLAUSES AND DELEGATION PROVISIONS UNDER CONTEMPORARY LAW

Over the last decade, the Supreme Court has strengthened the reach of forced arbitration agreements – agreements corporations bury in the fine print of contracts with consumers and workers that deny them the right to sue the corporation in court. Two Supreme Court decisions have led this push: *Rent-a-Center v. Jackson* (2010) 561 U.S. 63, which made it harder to challenge the enforceability of arbitration clauses, and *AT&T Mobility v. Concepcion* (2011) 563 U.S. 333, which upheld class-action waivers and narrowed the permissible types of state-law defenses to arbitration clauses. While there is much to despair, arbitration clauses are not unassailable. This article explains how to challenge arbitration clauses to hold corporations accountable for wage theft, discrimination, and consumer fraud.

Arbitrability – who decides?

Who decides – the court or the arbitrator – the enforceability and scope of the arbitration clause. The who-decides question is referred to by the case law as "arbitrability." This gateway question of arbitrability is by default left to the courts. "[A] gateway dispute about whether the parties are bound by a given arbitration clause raises a 'question of arbitrability' for a court to decide." (*Howsam v. Dean Witter Reynolds, Inc.* (2002) 537 U.S. 79, 84.) This default rule permits courts to decide whether an arbitration agreement was formed, whether the terms of the agreement cover the dispute at issue, or whether the arbitration agreement is enforceable under substantive doctrines like unconscionability or fraud. (*Ibid.*)

The FAA expressly permits a party to challenge the enforceability or validity of an arbitration clause. This follows from the text of section 2 of the Federal Arbitration Act's so-called "savings clause," stating that all arbitration agreement "shall be valid, irrevocable, and enforceable, *save upon such grounds as exist at law or in equity for the revocation of any contract*." (9 U.S.C. § 2.) But the Supreme Court has interpreted the savings clause narrowly. The Supreme Court has said that challenges under the savings clause must specifically go to the arbitration clause. A party may not invoke the savings clause to invalidate an arbitration agreement based on a challenge to other provisions of the contract or the contract as a whole, even if such challenges would invalidate the entire contract. "[A]s a matter of substantive federal arbitration law, an arbitration provision is severable from the remainder of the contract. . . . [U]nless the challenge is to the arbitration clause itself, the issue of the contract's validity is considered by the arbitrator in the first instance." (*Buckeye Check Cashing, Inc. v. Cardegna* (2006) 546 U.S. 440, 445-46). For example, when the consumer goes into court and argues fraud based on a separate provision of the contract – e.g., "This arbitration clause is invalid because the contract said the dealer would sell me a genuine Porsche but the Porsche was a fake" – *Buckeye Check* dictates that fraud that goes to a provision separate from the arbitration clause (e.g., the thing being sold) is an issue for the arbitrator.

The "Separability Principle"

The holding in *Buckeye Check* (which actually originates from *Prima Paint Corp. v. Flood & Conklin Mfg. Co.* (1967) 388 U.S. 395, which is more fully described below), that an arbitration clause is severable from the contract as a whole is called the The Separability Principle, and has resulted in three types of challenges to arbitration clauses, two of which can be successful.

First, a challenge that no contract ever formed satisfies the Separability Principle because this challenge would also mean no arbitration clause ever formed either. (See *Buckeye Check*, 546 U.S. at 444 fn. 1.) Contract formation challenges include issues of whether the party resisting arbitration ever signed the contract (*Chastain v. Robinson-Humphrey Co.* (11th Cir. 1992) 957 F.2d 851), or whether the individual signing the contract lacked authority to do so on behalf of the corporation. (*Sandvik AB v. Advent Int'l Corp.* (3d Cir. 2000) 220 F.3d 99.)

Similarly, issues of offer, acceptance, and consideration – three prerequisites to contract formation – would satisfy the Separability Principle, resulting in an unenforceable arbitration clause. The statute is clear that the court enforcing the arbitration clause – not the arbitrator – must be "satisfied that the *making* of the agreement for arbitration . . . is not in issue." (9 U.S.C. § 4 (emphasis added).) "Making" means "the act or process of forming, causing, doing or coming into being." ("Making," *Merriam-Webster Dictionary* (11th ed. 2020).) A court must therefore be satisfied that an arbitration agreement was made before enforcing it. Contract-formation challenges touch the source of legitimacy of arbitration as a matter of consent. "[A]rbitration 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." (*Howsman*, 537 U.S. at 83). Because consent is the theoretical underpinning of arbitration law, an agreement must be shown to have been "made" before it can be enforced.

Second, a defense that applies equally to the contract as a whole and to the arbitration clause is for the court, not the arbitrator, to decide. For example, a

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defense that the party had the mental capacity to enter into a contract applies equally to the contract as a whole and to the arbitration clause, thus leaving the defense for the court to decide. (*Spahr v. Secco* (10th Cir. 2003) 330 F.3d 1266.) The rationale behind these cases is that the challenge at issue "naturally goes to both the entire contract and the specific agreement to arbitration in the contract." (*Id.* at 1273.) As a matter of logic, a party cannot have capacity to enter into one kind of provision in a contract (e.g., the arbitration clause), but lack capacity to enter into a different kind of provision (e.g., the sale of a car). A party without capacity lacks capacity to agree to *any* provision in a contract, including an arbitration clause. (See *Spahr*, 330 F.3d at 1273; see also *In re Morgan Stanley & Co., Inc.* (Tex. 2009) 293 S.W.3d 182, 190 [holding mental capacity challenge to contract containing arbitration clause is "reserve[d] to the court"].)

Another capacity defense in California is that the party was a minor at the time of entering into the contract. Generally, a party who is a minor at the time of entering into the contract has a right to disaffirm the contract. (*Coughenour v. Del Taco, LLC* (2020) 57 Cal.App.5th 740, 750 [holding minor successfully disaffirmed contract with arbitration clause]; *Berg v. Traylor* (2007) 148 Cal.App.4th 809, 820 [reversing arbitration award because minor was entitled to disaffirm arbitration agreement].) This defense to the contract applies equally to the whole contract and the arbitration clause contained therein.

Third, arbitrators do not decide defenses going specifically to the arbitration clause itself unless there is a delegation provision (more fully described below). Courts generally decide such defenses. This rule has a more well-known flip side: Resolution of a defense that is premised solely on a provision having nothing to do with an arbitration clause (e.g., a usurious interest rate or fraud based on a counterfeit product) is left to the arbitrator, even if the defense would strike down the whole contract. This rule flows from the Supreme Court's decision in *Prima Paint Corp. v. Flood & Conklin Mfg. Co.* (1967) 388 U.S. 395. In *Prima Paint*, the Supreme Court held that a claim of "fraud in the inducement of the arbitration clause itself" is one "the federal court may proceed to adjudicate," but a "federal court [may not] consider claims of fraud in the inducement of the contract generally." (*Id.* at 403-04; see also *Buckeye Check*, *supra*, 546 U.S. at 445-46 ["[U]nless the challenge is to the arbitration clause itself, the issue of the contract's validity is considered by the arbitrator in the first instance."].)

Unconscionability

Similarly, one of the most common defenses to arbitration is unconscionability. For the court to decide unconscionability, the party must argue the arbitration clause itself is unconscionable. Federal courts do not decide unconscionability of the contract as a whole, or other provisions, when there is a valid arbitration clause. Unconscionability of an arbitration clause means the clause itself unfairly benefits the party with superior bargaining power. The same rule applies to defenses of fraud or duress. Absent fraud or duress in the formation of the arbitration clause, the arbitrator will decide any fraud or duress defense as to other provisions of the contract. (See *Prima Paint*, 388 U.S. at 403-04).

The presumption in favor of arbitration

In deciding whether a dispute is subject to arbitration, courts decide the scope of the arbitration clause and apply a "presumption of arbitrability.'" (*AT&T Techs., Inc. v. Commc'ns Workers of Am.* (1986) 475 U.S. 643, 650.) While the presumption is required by precedent, the presumption has no basis in the text, structure, or history of the Federal Arbitration Act.

In fact, the FAA directs courts to simply enforce the arbitration agreement "in accordance with the terms of the agreement." (16 U.S.C. § 16). The Supreme Court may be poised to re-evaluate the presumption based on comments in recent oral arguments. (See Tr. of Oral Arg. at 15:6-18, *Harry Schein, Inc. v. Archer & White Sales, Inc.*, 592 U.S. ___ (2021) (slip op.) (Justice Alito noting that the FAA "requires equal treatment of arbitration contracts and other contract," which calls into question the "basis for saying that there is this federal policy that produces the presumption" of arbitrability); *id.*at 24:6-21 (Justice Gorsuch questioning "[t]hese presumptions that we recognized in our case law" because the FAA "seems to suggest we follow normal contract rules in trying to discern the parties' intentions").)

To preserve this claim for any appeal, you should include a challenge to the presumption of arbitrability in the trial court briefs. The presumption generally has no application to narrowly drafted arbitration clauses. (*Chelsea Family Pharmacy, PLLC v. Medco Health Sols., Inc.* (10th Cir. 2009) 567 F.3d 1191, 1197 ["When considering narrow arbitration clauses, this liberal policy does not create a presumption of arbitrability because the policy favoring arbitration "does not have the strong effect ... that it would have if we were construing a broad arbitration clause."].)

The requirement that enforceability defenses must specifically challenge the arbitration clauses means the challenger's contentions must be carefully framed to the nature, scope, and content of the arbitration clause at issue. Under *Buckeye Check*, a party cannot claim the arbitration clause is voidable because the contract as a whole was illegal and thus void ab initio. (*Buckeye Check*, *supra*, 546 U.S. at 444.) The challenge in *Buckeye Check* was that the contract charged usurious interest rates, rendering the agreement unlawful and "criminal on its face." (*Id.* at 443.) As the First Circuit has explained, "a federal court must not remove from the arbitrators consideration of a substantive challenge to a contract unless there has been an independent challenge to the marking of the arbitration clause itself." (*Unionmutual Stock Life Ins. Co. v. Ben. Life Ins. Co.* (1st Cir. 1985) 884 F.2d 524, 529.)

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Traps for the unwary: The emerging law on "delegation provisions"

As noted above, the Supreme Court has held that defenses of invalidity that go to the contract as a whole are issues to be determined by the arbitrator, but defenses that go specifically to the arbitration clause are to be determined by the court. Can an agreement delegate enforceability issues reserved by default for the court to the arbitrator as well? Yes, and these clauses are exploding in arbitration clauses. Fortunately, the Supreme Court has adopted a strong presumption that disputes about the scope, validity, or enforceability of arbitration clauses are for a court to decide. (*First Options of Chi., Inc. v. Kaplan* (1995) 514 U.S. 938, 945.) A court may only require that parties arbitrate such disputes if there is "clear and unmistakable evidence" that the parties agreed to do so. (*Henry Schein, Inc. v. Archer & White Sales, Inc.* (2019) 139 S. Ct. 524, 530.) In this manner, "silence or ambiguity" is not enough to show the parties intended to submit arbitrability disputes – i.e., those disputes regarding the scope, validity, or enforceability of the arbitration clause itself – to the arbitrator. (*First Options*, 514 U.S. at 944-45.)

This standard sets a high bar. In fact, the Supreme Court has found such "clear and unmistakable evidence" in only a single case. The clause at issue read: "The 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." (*Rent-A-Ctr., W., Inc. v. Jackson* (2010) 561 U.S. 63, 66.). Because the plaintiff's claim of unconscionability as to the arbitration clause was a "dispute relating to the . . . enforceability or formation of this Agreement," the agreement left resolution of such dispute "exclusive[ly]" to the arbitrator. (*Ibid.*)

Courts have found the "clear and unmistakable" language required by *First Options* with much more equivocal language than *Rent-A-Center*. Most commonly, courts have found the incorporation by reference to the consumer or commercial American Association of Arbitration (AAA) Rules can be a valid delegation clause. The AAA Rules contain the following provision: "[A]rbitrator shall have the power to rule on his or her own jurisdiction, including any objections with respect to the ... validity of the arbitration agreement." (*Brennan v. Opus Bank* (9th Cir. 2015) 796 F.3d 1125, 1128.)

This provision does no more than give the arbitrator the authority to determine arbitrability. It does not follow from this power-granting provision that a court's traditional authority to determine arbitrability is preempted or displaced or that the arbitrator's authority to determine arbitrability is exclusive. Unlike the *Rent-A-Center*'s provision giving the arbitrator "exclusive authority," the AAA provision does not clearly and unmistakably divest the courts of their default authority.

While the appellate courts have uniformly held incorporation of AAA Rules is a valid delegation clause under *First Options*, the Supreme Court itself has expressed doubts from Justices across the ideological spectrum. In *Schein*, the party asserted the incorporation of the AAA Rules was a valid delegation provision. The issue on appeal was whether assuming the delegation provision was valid a wholly groundless exception to a delegation provision existed. At oral argument, Justice Ginsburg was skeptical of the premise she was asked to assume on appeal, pointing to the fact that the "model case [in] this Court's [*Rent-A-Center*] decision . . . said the arbitrator, not the court, has exclusive authority. And here we – we're missing both the arbitrator to the exclusion of the court, and the arbitrator has exclusive authority." (Tr. of Oral Argument at 7, 18, *Schein* (No. 17-1272) 139 S. Ct. 524.)

Justice Gorsuch signaled, "[T]here's just maybe a really good argument that clear and unmistakable proof doesn't exist in this case of a desire to go to arbitration and have the arbitrator decide arbitrability?" (*Id.* at 42.) Because the issue is unsettled by the Supreme Court, it is necessary to continue to raise the argument that incorporation of the AAA Rules is not a clear and unmistakable delegation clause to preserve the argument.

What remains unsettled in the Ninth Circuit is whether incorporation of the AAA Rules is a valid delegation where the party is not sophisticated. The *Opus Bank* court expressly left this question open. (*Opus Bank*, 796 F.3d at 1131 ["[W]e limit our holding to the facts of the present case, which do not involve arbitration agreement 'between sophisticated parties.'"].) District courts have reached different conclusions regarding the issue left open by *Opus Bank*, with a large number holding that incorporation of AAA Rules is not a valid delegation clause where a party is unsophisticated. (See, e.g., *Calzadillas v. Wonderful Co., LLC* (E.D. Cal., June 3, 2019, No. 119– CV–00172DADJLT) 2019 WL 2339783, at *4; *DeVries v. Experian Info. Sols., Inc.* (N.D. Cal., Feb. 24, 2017, No. 16–cv–02953–WHO) 2017 WL 733096, at *10; *Ingalls v. Spotify USA, Inc.*, (N.D. Cal., Nov. 14, 2016, No. 16–cv–03533), 2016 WL 6679561, at *3; *Mikhak v. Univ. of Phoenix*, No. (N.D. Cal., June 21, 2016, 16–cv–00901) 2016 WL 3401763, at *5; *Money Mailer, LLC v. Brewer* (W.D. Wash., Apr. 8, 2016, No. C15– 1215RSL) 2016 WL 1393492 at *2; *Vargas v. Delivery Outsourcing, LLC* (N.D. Cal., Mar. 14, 2016, No. 15–cv–03408–JST) 2016 WL 946112, at *7–8; *Meadows v. Dickey's Barbecue Rests. Inc.* (N.D. Cal. 2015) 144 F.Supp.3d 1069, 1079.) To support this argument, it is essential to develop a factual record showing the client is unsophisticated through declarations and other admissible evidence.

California law on "delegation"

In California, courts have also ruled that a delegation provision is not "clear and unmistakable" if other provisions in the same contract render it ambiguous. Thus, for example, in *Peleg v. Nieman Marcus Group, Inc.* (2012) 204 Cal.App.4th 1425, the Court of Appeal concluded a delegation provision was not clear and

unmistakable because the contract's severability provision noted that "If any *court* determines that this Agreement in its entirety shall not be enforced," such *judicial* determination would be effective only in the state of the court. (*Id*. at 1442). Because the provision presupposed a court would determine enforceability issues, such provision rendered the delegation provision ambiguous. *Peleg* collected cases with similar holdings. (*Ibid.*) The lesson from *Peleg* is – sorry to be a broken record – to read the entire contract carefully to identify clauses that render a delegation provision ambiguous.

Assuming a delegation clause exists, challenges to delegation clauses mimic the doctrinal framework for challenging arbitration clauses. That is, the party resisting a delegation clause must challenge the delegation clause specifically. "[U]nless [the party] challenged the delegation provision specifically, we must treat it as valid under [the FAA], and must enforce it . . . leaving any challenge to the validity of the Agreement as a whole for the arbitrator. (*Rent-A-Ctr.*, 561 U.S. at 72). If the party resisting a delegation clause does not specifically challenge that specific clause, the argument is waived. (*Id.* at 72-73, 75 [challenges to arbitration clause "need not [be] consider[ed] because none of [plaintiff's] substantive unconscionability challenges was specific to the delegation provision" and challenges to delegation provision specifically on appeal were waived].)

Because there are so few cases, it remains to be seen what a successful challenge to a delegation provision looks like. At the very least, the same theoretical Russian Dolls framework described above applies. Thus, contract formation defenses – which would logically mean the delegation provision in the contract was never formed – would require resolution by the court. Examples include the absence of authority to enter into the contract (e.g., power of attorney cases, which are common in the nursing home setting, or agents of a corporation), the absence of consent (e.g., the delegation provision was not part of the contract the party accepted), or a forged signature. Similarly, a defense that applies equally to the contract as a whole and the delegation provision specifically (e.g., the lack of capacity defense, minors) would require resolution by the Court as well. If neither of the foregoing applies, then the third category of challenges noted above – a defense that goes specifically to the delegation provision itself – becomes a bit challenging, as there are few variations in a delegation provision, but that "does not mean they are unassailable." (*Rent-A-Center*, 561 U.S. at 70.)

California courts have held that "clear delegation clauses . . . are substantively unconscionable only if they impose unfair or one-sided burdens that are different from the clauses' inherent features and consequences." (*Pinela v. Nieman Marcus Group, Inc.* (2015) 238 Cal.App.4th 227, 245.) There are two lines of cases in California showing unconscionability of a delegation provision.

On the one hand, some California courts have held that delegation clauses are substantively unconscionable because of the practical effects of an otherwise facially neutral delegation provision. In other words, the language of the delegation provision does not, on its face, favor one party or the other, but the enforcement and application of the delegation provision favors the party with superior bargaining power. This disparate impact favoring the stronger party makes it structurally harder for the weaker party to win in two ways: (1) the worker or consumer is more likely to bring enforcement challenges, making them more frequently subject to the delegation provision; and (2) arbitrators "could be invested in the outcome" of a challenge to the enforceability of an arbitration agreement, as arbitrators are paid by the number of arbitrations they do and striking down an arbitration agreement means fewer arbitrations and thus less money. (See *Ontiveros v. DHL Express (USA), Inc.* (2008) 164 Cal.App.4th 494.)

On the other hand, other California courts have held that delegation provisions are substantively unconscionable because the provision favors one party on its face. In *Pinela*, the Court held that the delegation provision was substantively unconscionable because the agreement prohibited the arbitrator from applying California law in ruling on the California employee's unconscionability claim. (*Pinela*, 238 Cal.App.4th at 246.) In *Pinela*, the agreement required the arbitrator to apply Texas law and expressly did "not have the authority to enlarge, add to, subtract from, disregard, or . . . otherwise alter the parties' rights under such laws." (*Ibid.*) The express language of the choice of law clause was significant to the Court's ruling, as the choice of law clause prohibited the arbitrator from selecting California law to the extent necessary to render it enforceable. (*Id.* at 248.) Because the employer in *Pinela* was headquartered in Texas and the employee a resident in California, the delegation provision coupled with the choice of law clause substantively favored the employer. This burden on the employee is "not an inherent feature or consequence of delegation clauses generally." (*Id.* at 249-250.)

Summary

In summary, the key to challenging arbitration clauses is to read them carefully and look for the following, in order of priority:

A delegation provision – a provision giving the arbitrator the authority to decide the enforceability and scope of the arbitration clause. Such a provision must be "clear and unmistakable." If a delegation provision exists:

Read it carefully. If the delegation provision grants the arbitrator "exclusive" authority to rule on the enforceability or scope of the arbitration clause, it is probably "clear and unmistakable."
If the language gives the arbitrator such authority but does not grant the arbitrator the exclusive authority, argue that the provision is not clear and unmistakable because the provision can be read to grant authority *concurrently* with the court's default authority. If the

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arbitration clause incorporates AAA Rules, then it may be a delegation clause. If the arbitration clause incorporates rules of another arbitration association, then read the rules carefully.

If the basis for a delegation provision is the incorporation of AAA Rules, argue the holding of *Brennan v. Opus Bank* does not apply to unsophisticated clients. Submit a declaration demonstrating with evidence that the client is unsophisticated.

Investigate whether a defense going to the formation of the delegation provision itself exists, rendering the delegation provision itself void. Such a defense cannot depend on a different provision of the contract, but must go directly to the delegation provision as though it were a standalone agreement. For example, if the client is a minor, one argument is that the client has a right to disaffirm the delegation provision, as his or her incapacity applies equally to every provision of the contract. Another defense may be unconscionability, but it is critical to focus on unconscionable elements of the delegation provision rather than those of the arbitration clause.

The arbitration clause – Absent a delegation provision, the court decides on the enforceability and scope of the *arbitration clause*. However, the court does not decide on the enforceability of the contract itself. Do not argue the contract as a whole is unenforceable, as there is a long line of Supreme Court holdings that such issues of contract enforceability are for the arbitrator.

Read the arbitration clause carefully. If the clause is narrow, then there are cases saying no presumption of arbitrability exists. If the clause is broad, then there is a federal presumption of arbitrability. Challenge the presumption of arbitrability as inconsistent with the FAA, as there may be a chance the Supreme Court will re-evaluate the presumption, which has no basis in the text of the FAA, in the near term.

If the clause covers the dispute, challenge the enforceability of the arbitration clause itself. The most frequent defense is unconscionability, but the unconscionability must go to the arbitration clause itself.

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