No. 14-1458

In the
Supreme Court of the United States

MHN GOVERNMENT SERVICES, INC., et al.,

Petitioners,

v.

THOMAS ZABOROWSKI, et al.,

Respondents.

On Writ of Certiorari to the United States Court of Appeals for the Ninth Circuit

BRIEF AMICUS CURIAE OF PACIFIC LEGAL FOUNDATION IN SUPPORT OF PETITIONERS

DEBORAH J. LA FETRA
Counsel of Record
Pacific Legal Foundation
930 G Street
Sacramento, California 95814
Telephone: (916) 419-7111
Facsimile: (916) 419-7747
E-mail: dlafetra@pacificlegal.org

Counsel for Amicus Curiae Pacific Legal Foundation

QUESTION PRESENTED

The Federal Arbitration Act (FAA) provides that an arbitration agreement shall be enforced "save upon such grounds as exist at law or in equity for the revocation of any contract," 9 U.S.C. § 2. California law applies one rule of contract severability to contracts in general, and a separate rule of contract severability to agreements to arbitrate. The arbitration-only rule disfavors arbitration and applies even when the agreement contains an express severability clause. Its application in this case conflicts with binding precedent of this Court and with opinions of four other courts of appeals.

The question presented is whether California's arbitration-only severability rule is preempted by the FAA.

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INTEREST OF AMICUS CURIAE

Pursuant to Supreme Court Rule 37, Pacific Legal Foundation respectfully submits this brief amicus curiae in support of Petitioner, MHN Government Services, Inc.[1] Founded in 1973, Pacific Legal Foundation (PLF) is widely recognized as the most experienced nonprofit legal foundation of its kind. PLF's Free Enterprise Project defends the freedom of contract, including the right of parties to agree by contract to the process for resolving disputes that might arise between them. To that end, PLF has participated as amicus curiae in many important cases in this Court, the California courts and many other state supreme courts involving the Federal Arbitration Act (FAA) and contractual arbitration in general. *See, e.g.*, *DIRECTV v. Imburgia*, No. 14-462 (pending); *Oxford Health Plans LLC v. Sutter*, 133 S. Ct. 2064 (2013); *AT&T Mobility v. Concepcion*, 131 S. Ct. 1740 (2011); *Rent-A-Center, W., Inc. v. Jackson*, 561 U.S. 63 (2010); *Stolt-Nielsen S. A. v. AnimalFeeds Int'l Corp.*, 559 U.S. 662 (2010); *Hall Street Assocs., L.L.C. v. Mattel, Inc.*, 552 U.S. 576 (2008); *Preston v. Ferrer*, 552 U.S. 346 (2008); *Sanchez v. Valencia Holding Co.*, 61 Cal. 4th 899 (2015); *Iskanian v. CLS Transp.*, 59 Cal. 4th 348 (2014), *cert. denied*, 135 S. Ct. 1155 (2015); *Gentry v. Superior Court (Circuit City Stores, Inc.)*, 42

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[1] Pursuant to this Court's Rule 37.3(a), all parties have consented to the filing of this brief. Letters evidencing such consent have been filed with the Clerk of the Court.

Pursuant to Rule 37.6, Amicus Curiae affirms that no counsel for any party authored this brief in whole or in part, and no counsel or party made a monetary contribution intended to fund the preparation or submission of this brief. No person other than Amicus Curiae, its members, or its counsel made a monetary contribution to its preparation or submission.

Cal. 4th 443 (2007). PLF supported the petition for writ of certiorari in this case.

INTRODUCTION AND SUMMARY OF ARGUMENT

MHN Government Services, Inc. is a private company that runs a healthcare-consulting business and employs graduate-school-educated healthcare workers. Pet. App. 12a-13a. The employees claim they were misclassified as independent contractors rather than employees, and that they were consequently deprived of overtime pay in violation of federal and state laws. Pet. App. 13a. Despite their employment contracts' arbitration agreement, a putative class of employees sued the company in federal court. MHN moved to compel the workers to resolve their claims in arbitration. *Id*. The employees argued that multiple provisions of the agreement were unconscionable. The district court agreed with them as to five discrete provisions ancillary to the basic underlying agreement to arbitrate: a shortened 6-month limitations period; waiver of punitive damages; a $2600 filing fee; a fee-shifting clause that awards attorneys' fees to the prevailing party; and an arbitrator-selection clause that allowed the employer to unilaterally choose a pool of three arbitrators from which the employee could then select its choice of arbitrator. Pet. App. 20a-28a. Under the California Supreme Court decision in *Armendariz v. Found. Health Psychcare Svcs., Inc.*, 24 Cal. 4th 83, 124 (2000), if a court finds "more than one unlawful provision" in an arbitration agreement to be unconscionable, it will deny severance and refuse to enforce the agreement in its entirety. Applying this principle, the Ninth Circuit Court of Appeals declined

to sever the offensive provisions, and instead invalidated the entire agreement. Pet. App. 5a.

In the general contractual context, a court applying California law can withhold severance only if it finds, after a fact-intensive provision-by-provision analysis, that the unconscionable provisions truly permeate and infect the entirety of the contract. The court below applied the *Armendariz* severance rule: that a court should refuse to sever unconscionable provisions in an arbitration agreement, whether or not the offensive provisions permeate and infect the entirety of the contract. In so doing, it applies severance doctrine contrary to state statutes that permit severance of multiple discrete provisions, and disfavors arbitration agreements by facilitating invalidation of entire arbitration agreements. In *AT&T Mobility, LLC v. Concepcion*, 131 S. Ct. at 1747, this Court held that the FAA preempts state-law rules that treat arbitration agreements less favorably than other contracts, or even have a "disproportionate impact on arbitration agreements." Judge Gould correctly would have held the *Armendariz* severance rule preempted by the FAA under *Concepcion*, severed the offensive provisions, and held the parties to their contractual agreement to arbitrate. Pet. App. 8a, 11a.

This Court should now explicitly hold that *Armendariz* was abrogated by *Concepcion*. *Armendariz*'s approach to severability of provisions in arbitration contracts is uniquely adverse compared to general state contract law of severability, in violation of the federal substantive law of arbitration and the Federal Arbitration Act, both of which require that arbitration contracts be considered on an equal footing to all other contracts. By refusing to sever invalid

provisions in favor of striking down arbitration contracts in their entirety, the Ninth Circuit, applying California law, defeats parties' legitimate expectations of arbitral resolution of disputes, thus harming the rule of law. The violation of the parties' intent is particularly acute where, as here, the contract contains a severability clause.

The severability rule also implicates another aspect of *Armendariz*, with which it works in concert. The severance rule requires California courts to invalidate an arbitration contract if there are two (or more) unconscionable provisions. Compounding the effect of this rule is that in many cases, one of the two "unconscionable" aspects of the contract is a "lack of mutuality," a California contract doctrine (explicitly rejected by most other states) that *Armendariz* requires be employed almost exclusively to arbitration contracts. The California courts demand that arbitration contracts—but not other contracts—have "mutual" provisions such that both parties stand in precise equivalence. A lack of mutuality is deemed unconscionable, and thus provides the first strike against an arbitration contract. Under *Armendariz*, one strike is all the contracting parties get. If any other provision is found unconscionable, the *Armendariz* "permeation" rule requires that the arbitration contract be invalidated in its entirety.

The decision below should be reversed.

ARGUMENT

I

THE *ARMENDARIZ* SEVERABILITY RULE DISFAVORS ARBITRATION CONTRACTS

A. The Federal Arbitration Act Mandates That Arbitration Contracts Stand on an Equal Footing with Other Contracts

Congress enacted the Federal Arbitration Act, 9 U.S.C. §§ 1-16, to overcome judicial resistance to arbitration and the savings clause of Section 2 embodies the national policy favoring arbitration and places arbitration agreements on equal footing with all other contracts. *Buckeye Check Cashing, Inc. v. Cardegna*, 546 U.S. 440, 443 (2006). Applying this federal substantive law to the states, courts must construe arbitration contracts the same as any other contract, not subject it to more stringent review or disfavor because the subject matter is arbitration. *Id.*, confirming the holding of *Southland Corp. v. Keating*, 465 U.S. 1, 16 (1984).

The liberal interpretation of arbitration contracts is based on the freedom of competent adults to make their own decisions as to how to resolve disputes. *Concepcion*, 131 S. Ct. at 1745, 1749; *Dean Witter Reynolds Inc. v. Byrd*, 470 U.S. 213, 220 (1985) (the Arbitration Act manifested "congressional desire to enforce agreements into which parties had entered"); *Mitsubishi Motors Corp. v. Soler Chrysler-Plymouth, Inc.*, 473 U.S. 614, 625 (1985) ("The 'liberal federal policy favoring arbitration agreements' . . . is at bottom a policy guaranteeing the enforcement of private

contractual arrangements."). The FAA preempts state law that "conditions the enforceability of arbitration agreements on compliance with a special notice requirement not applicable to contracts generally." *Doctor's Assocs., Inc. v. Casarotto*, 517 U.S. 681, 687 (1996). As such, courts must "place arbitration agreements on an equal footing with other contracts and enforce them according to their terms." *Concepcion*, 131 S. Ct. at 1745 (citations omitted).

The FAA's preemptive effect extends to grounds that generally exist "at law or in equity for the revocation of any contract[]" when those grounds "have been applied in a fashion that disfavors arbitration." *Id*. at 1747 (emphasis added). Thus, it does not allow courts to fashion contract law principles that "stand as an obstacle to the accomplishment of the FAA's objectives." *Id.* at 1748. That is, a court may not "decide that a contract is fair enough to enforce all its basic terms (price, service, credit), but not fair enough to enforce its arbitration clause." *Allied-Bruce Terminix Cos. v. Dobson*, 513 U.S. 265, 281 (1995).

California's general rule of contract law governing severability is that an invalid provision will be severed unless the invalidity "permeates" the entire contract, rendering it unlawful. Cal. Civ. Code § 1670.5 ("If the court as a matter of law finds the contract or any clause of the contract to have been unconscionable at the time it was made the court may refuse to enforce the contract, or it may enforce the remainder of the contract without the unconscionable clause, or it may so limit the application of any unconscionable clause as to avoid any unconscionable result."); Cal. Civ. Code § 1599 ("Where a contract has several distinct objects, of which one at least is lawful, and one at least is

unlawful, in whole or in part, the contract is void as to the latter and valid as to the rest."). *See also Birbrower, Montalbano, Condon & Frank v. Superior Court*, 17 Cal. 4th 119, 137 (1998) (relying on Section 1599 to sever invalid portions of lawyers' fee agreement). In *Dotson v. Amgen, Inc.*, 181 Cal. App. 4th 975, 986 (2010), the California Court of Appeal held that "[a]lthough 'the statutes appear to give a trial court discretion as to whether to sever or restrict the unconscionable provision or whether to refuse to enforce the entire agreement[,] . . . it also appears to contemplate the latter course *only* when an agreement is 'permeated' by unconscionability.' " (Emphasis added; citations omitted).

As shown below, ordinary contracts not involving arbitration often have one or more unconscionable provisions severed; in such contracts there is no apparent presumption that more than one invalid or unconscionable provision so "permeates" the contract to render the entire contract void. But arbitration contracts are uniquely analyzed under *Armendariz*: whenever there is simply more than one unconscionable provision in an arbitration contract, that unconscionability is presumed to permeate the entire contract, with the result that California courts invalidate the entirety of many arbitration contracts, instead of just the offending provisions. So long as an arbitration contract contains only a single unconscionable provision, California courts sever the offending provision and uphold the rest of the contract. *Armendariz* established the rule, however, that if more than one of these otherwise severable provisions exist in a single contract, unconscionability is deemed to permeate the agreement, rendering it fully invalid and unenforceable. 24 Cal. 4th at 124, cited in Pet. App. at

5a. The *Armendariz* court voiced the concern that it is not for the court to rewrite the contract for the parties. 24 Cal. 4th at 125. But "[p]artial enforcement [of a contract term] involves much less of a variation from the effects intended by the parties than total non-enforcement would." Arthur L. Corbin, *A Comment on Beit v. Beit*, 23 Conn. B.J. 43, 50 (1949), quoted in Omri Ben-Shahar, *Fixing Unfair Contracts*, 63 Stan. L. Rev. 869, 893 (2011). Disregarding this policy, the *Armendariz* bright-line rule stands as an obstacle to normal rules governing severance of invalid contract terms.

B. The *Armendariz* Rule That Multiple Discrete Provisions Necessarily Permeate a Contract Uniquely, and Adversely, Affects Arbitration Contracts

The key to *Armendariz*'s rule is its presumption that more than one invalid provision "permeates" an arbitration contract. The "permeated" language is important, because it distinguishes between invalid provisions that can be lined out without altering the basic agreement between the parties and invalid provisions that infect every essential provision, such that lining them out fundamentally alters the contract. None of the California arbitration cases actually define "permeate." However, in different contexts, California-based courts have defined the word to mean "to be diffused throughout," *People v. Bautista*, 115 Cal. App. 4th 229, 236 n.4 (2004), and "cannot be discretely separated from . . . [the] whole." *In re Grand Jury Subpoena (Mark Torf/Torf Environmental Management)*, 357 F.3d 900, 910 (9th Cir. 2004). These decisions recognize that permeation does not

depend solely on the size or quantity of the offending elements, but rather on the extent to which they affect every other aspect of the whole.[2]

The *Armendariz* decision reflects the court's hostility to arbitration by presuming that more than one unconscionable provision per se permeates the entire agreement, requiring that the agreement be invalidated in its entirety. 24 Cal. 4th at 124. While permitting severance of a single, discrete invalid provision, *Armendariz* offers no logical justification (beyond the presumption of permeation) for refusing to sever two, three, or more provisions, if the subject matter of those provisions are *also* sufficiently discrete from the primary subject of the contract. *See Spinetti v. Service Corp. Int'l*, 324 F.3d 212, 214 (3d Cir. 2003) (severing multiple provisions to uphold an arbitration contract, noting "You don't cut down the trunk of a tree because some of its branches are sickly.").

As the law of arbitration has evolved, California courts have identified many types of provisions as unconscionable and severed them, so long as no more than one provision is unconscionable:

For example, an attorneys' fee shifting provision was held unconscionable and severed from the contract. *See, e.g.*, *Serpa v. California Surety*

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[2] Analogously, in the context of criminal cases, a constitutional "structural error" is one that "permeate[s] '[t]he entire conduct of the trial from beginning to end,' or 'affect[s] the framework within which the trial proceeds.'" *Rice v. Wood*, 77 F.3d 1138, 1141 (9th Cir. 1996). Because they require automatic reversal (the equivalent of striking down an entire arbitration contract), structural errors that permeate the entire proceeding are held to occur in only a "very limited class of cases." *Johnson v. United States*, 520 U.S. 461, 468 (1997).

Investigations, Inc., 215 Cal. App. 4th 695, 710 (2013) (offending attorney fee provision severed as "plainly collateral to the main purpose of the contract" and remainder of arbitration agreement enforced).

Costs provisions have been held unconscionable and severed from the contract. *See, e.g.*, *Gutierrez v. Autowest, Inc.*, 114 Cal. App. 4th 77, 92 (2003) (severing costs provision and enforcing the balance of the arbitration agreement; the central purpose of the contract "was not to regulate costs, but to provide a mechanism to resolve disputes [and] [b]ecause the costs provision is collateral to that purpose, severance was available.").

Unilateral appeal provisions have been held unconscionable and severed from the contract. *See, e.g.*, *Little v. Auto Steigler, Inc.*, 29 Cal. 4th 1064, 1075-76 (2003).

A provision limiting discovery may be held unconscionable and severed from an otherwise valid arbitration contract. *See, e.g.*, *Dotson*, 181 Cal. App. 4th at 985.

There is no logical reason why each of these provisions is described as discrete and collateral to the main objective of the contract in isolation, but the same discrete and collateral provisions in combination are deemed to permeate every aspect of a contract.

The *Armendariz* more-than-one permeability rule serves as nothing more than a fiction designed to invalidate arbitration contracts, a fact illuminated by the willingness of federal courts to routinely sever more than one unconscionable provision without finding a permeability problem. Demonstrating that the *Armendariz* rule unnecessarily invalidated

arbitration contracts, several district court decisions refuse to apply the bright-line rule that more-than-one unconscionable provision equals permeation by assessing whether the unconscionable provisions are, in fact, central to the arbitration contract and affect all facets. If discrete provisions can be severed without harming the parties' general intent to resolve disputes in arbitration, the district courts sever those provisions. For example, in *Lucas v. Gund, Inc.*, 450 F. Supp. 2d 1125, 1134 (C.D. Cal. 2006), the district court cited *Armendariz* but relied on the language of Cal. Civil Code § 1670.5 to sever two discrete, unconscionable provisions (one involving costs and fees; the other mandating New Jersey as the location for the arbitration). *See also*, *Ambler v. BT Americas Inc.*, 964 F. Supp. 2d 1169, 1177 (N.D. Cal. 2013) (severing two provisions relating to cost-splitting and attorneys' fees and otherwise enforcing the arbitration contract); *Silicon Valley Self Direct, LLC v. Paychex, Inc.*, 2015 WL 4452373, *7 (N.D. Cal. July 20, 2015) (severing damages waiver provision and forum selection clause to otherwise uphold an arbitration agreement).

Similarly, a district court severed three provisions—relating to carve-outs for injunctive and equitable relief, confidentiality, and attorneys' fees—and upheld an otherwise valid arbitration agreement. *Grabowski v. Robinson*, 817 F. Supp. 2d 1159, 1179 (S.D. Cal. 2011) (arbitration agreement was not "permeated by unconscionability," notwithstanding the three discrete, unconscionable provisions). *See also Hwang v. J.P Morgan Chase Bank, N.A.*, No. CV 11-10782 PSG (JEMx), 2012 WL 3862338 (C.D. Cal. Aug. 16, 2012) (severed invalid fee-sharing and modification provisions because they were "collateral

to the agreements" and "would not amount to rewriting the agreements."); *Bencharsky v. Cottman Transmission Systems, LLC*, 625 F. Supp. 2d 872, 883 (N.D. Cal. 2008) (severing multiple provisions limiting the statute of limitations, barring punitive damages, and awarding equitable relief to only one party, while upholding the remainder of the arbitration agreement); *Cox v. Station Casinos, LLC*, 2014 WL 3747605, *5 (D. Nev. June 25, 2014) (severing provisions "concerning procedure, costs, and relief" because "collateral" to the main purpose of the employment contract that contained an arbitration clause).

As these federal cases demonstrate, courts can sever multiple discrete provisions without rewriting the arbitration contract. By doing so, courts validate the intent of the parties to resolve their disputes in an arbitral forum, consistent with the Federal Arbitration Act and the federal substantive law of arbitration. By contrast, the *Armendariz* rule that requires invalidation of arbitration contracts by aggressively refusing to sever multiple, discrete, unconscionable terms, uniquely disfavors arbitration contracts.

II

THE *ARMENDARIZ* RULE IMPROPERLY DISCOUNTS PARTIES' INTENT TO SEVER INVALIDATED PROVISIONS AND RETAIN THE OVERRIDING GOAL OF ARBITRATING DISPUTES

The contract between the parties in this case contains an express severability clause. Pet. App. at 54a. As a general matter, "[p]arties agreeing to a severance clause may agree to sever any invalid or unenforceable provision from a contract such that the

remainder of the contract is unaffected and enforceable as provided by law." *SI V, LLC v. FMC Corp.*, 223 F. Supp. 2d 1059, 1063 (N.D. Cal. 2002). The rule adopted by *Armendariz* not only ignores the parties' stated intent to arbitrate their disputes, but also disregards the parties' stated intent to proceed pursuant to what remains of the agreement if any provisions are invalidated. *See Estate of Deresh ex rel. Schneider v. FS Tenant Pool III Trust*, 95 So. 3d 296, 301 (Fla. Dist. Ct. App. 2012) (severing a punitive damages provision from an arbitration contract because "*[r]efusing* to sever the punitive damages limitation would cut out the heart of the agreement for a peripheral illegality."); *Zuver v. Airtouch Comm'ns, Inc.*, 153 Wash. 2d 293, 320 (2004) (excising confidentiality and remedies provisions from an arbitration contract but enforcing the remainder because "the parties have explicitly expressed their intent for us to do so by agreeing to a severance clause.").

As the Eighth Circuit explained, "[w]e do not believe that the severance of the provision limiting punitive damages diminishes [the claimant's] contractual intent to arbitrate because excluding the provision only allows her the opportunity to arbitrate her claims under more favorable terms than those to which she agreed." *Gannon v. Circuit City Stores, Inc.*, 262 F.3d 677, 682-83 (8th Cir. 2001); *see also Booker v. Robert Half Int'l, Inc.*, 413 F.3d 77, 84 (D.C. Cir. 2005) (citing *Gannon*); *Morrison v. Circuit City Stores, Inc.*, 317 F.3d 646, 675 (6th Cir. 2003) ("when the arbitration agreement at issue includes a severability provision, courts should not lightly conclude that a particular provision of an arbitration agreement taints the entire agreement."). Courts that sever unlawful

provisions pursuant to an agreed-upon severance clause "enhance[] the ability of the arbitration provision to function fully and adequately under the law." *Hadnot v. Bay, Ltd.*, 344 F.3d 474, 478 (5th Cir. 2003).

The Washington Supreme Court's decision in *Gandee v. LDL Freedom Enterprises, Inc.*, 176 Wash. 2d 598 (2013), illustrates the difficulty of relying on numerical boundaries, *i.e.*, a set number of invalid provisions, to determine whether severability should apply, particularly when the agreement also contains a severance clause. In that case, the arbitration clause consisted of four sentences (plus the severance clause). The arbitration provisions read:

> All disputes or claims between the parties related to this Agreement shall be submitted to binding arbitration in accordance with the rules of [the] American Arbitration Association within 30 days from the dispute date or claim. Any arbitration proceedings brought by Client shall take place in Orange County, California. Judgment upon the decision of the arbitrator may be entered into any court having jurisdiction thereof. The prevailing party in any action or proceeding related to this Agreement shall be entitled to recover reasonable legal fees and costs, including attorney's fees which may be incurred.

The court held that the 30-day provision, the venue provision, and the loser-pays provision were unconscionable. *Id.* at 605-07. The court described this as invalidating three out of four sentences in the short arbitration clause, *id.* at 607, and held that 75%

invalidation left too little of consequence remaining for enforcement.

However, the court's three-out-of-four calculation does not accurately describe the effect of invaliding the unconscionable provisions. Had the court excised the offending provisions pursuant to the contract's severance clause, the arbitration clause would have required binding arbitration pursuant to the American Arbitration Association rules, the resulting decision of which could be entered into any appropriate court. While this seems bare bones, it suffices to indicate the parties' intent to arbitrate and incorporates a thorough set of rules under which the arbitration would proceed. Moreover, had the AAA Rules been spelled out rather than incorporated, those three invalidated provisions would have reflected a much tinier percentage of the whole. As a district court explained in nearly identical circumstances, "[a]lthough [defendant] inserted two clauses that appear to conflict with JAMS rules, simply severing those provisions or interpreting them as not applicable in California and proceeding under the incorporated JAMS rules cures the unconscionability as to those terms and preserves the intent of the Agreement." *Pope v. Sonatype, Inc.*, 2015 WL 2174033, *6 (N.D. Cal. May 8, 2015).

Courts looking to shortcut the analysis of whether unconscionable provisions "permeate" a contract—by simply counting the provisions—do a disservice to the parties' intent. *See Parilla v. IAP Worldwide Services, VI, Inc.*, 368 F.3d 269, 289 (3d Cir. 2004) ("[S]everability requires more than a count of the unconscionable provisions."). *Armendariz* requires just this simplistic approach, with the result that California courts routinely invalidate arbitration contracts in

their entirety rather than severing unconscionable provisions, an approach at odds with California courts willingness to sever provisions from non-arbitration contracts. Because this uniquely adverse affect on arbitration contracts violates the Federal Arbitration Act and the federal substantive law of arbitration, the *Armendariz* severability rule should be abrogated.

III

THE *ARMENDARIZ* RULE UNIQUELY AND ADVERSELY AFFECTS ARBITRATION CONTRACTS BY ITS APPLICATION OF THE MUTUALITY DOCTRINE

California courts increase the number of provisions deemed unconscionable by employing several doctrines holding arbitration contracts to different and higher standards than other contracts. A prime example is mutuality. As shown below, in California, mutuality is a major factor in determining whether an agreement is "permeated" with unconscionability. California courts demand mutuality *only* with regard to arbitration contracts, not other types of contracts. *Cf. Berent v. CMH Homes, Inc.*, 466 S.W.3d 740, 752 (Tenn. 2015) ("We are mindful that lack of mutuality of remedies in a contract is a type of 'one-sidedness' that is likely peculiar to arbitration agreements.").

A. *Armendariz*'s Mutuality Test Applies to All Arbitration Contracts in California

The "mutuality test" first appeared in *Stirlen v. Supercuts, Inc.*, 51 Cal. App. 4th 1519 (1997), which held that a contract that requires one party to arbitrate but not the other is so "one-sided" as to be unconscionable. *Id.* at 1532. The *Stirlin* court repeatedly labeled the contract between the parties as a "contract of adhesion" (an element of unconscionability), implicitly contradicting earlier California law by assuming that the label would be dispositive of the legal issues. *Id.* at 1533; *see also Kinney v. United HealthCare Services, Inc.*, 70 Cal. App. 4th 1322, 1332 (1999) (invalidating "unilateral obligation to arbitrate"). Yet this disdain of adhesion contracts itself betrays a certain bias.

> "The contract of adhesion is a part of the fabric of our society. It should neither be praised nor denounced . . . ." That is because there are important advantages to its use despite its potential for abuse. These advantages include the fact that standardization of forms for contracts is a rational and economically efficient response to the rapidity of market transactions and the high costs of negotiations, and that the drafter can rationally calculate the costs and risks of performance, which contributes to rational pricing.

Goodwin v. Ford Motor Credit Co., 970 F. Supp. 1007, 1015 (M.D. Ala. 1997) (citing *Roberson v. The Money Tree of Alabama, Inc.*, 954 F. Supp. 1519, 1526 n.6 & n.10 (M.D. Ala. 1997)).[3] *See also Concepcion*, 131 S. Ct.

at 1750 ("[T]he times in which consumer contracts were anything other than adhesive are long past."). Under the mutuality test, the court relies on its own speculation that the arbitral proceeding itself might impede a party's ability to obtain the requested relief. As the Ninth Circuit understood the California rule, "[w]here the party with stronger bargaining power has restricted the weaker party to the arbitral forum, but reserved for itself the ability to seek redress in either an arbitral or judicial forum, California courts have found a lack of mutuality supporting substantive unconscionability." *Nagrampa v. MailCoups, Inc.*, 469 F.3d 1257, 1285 (9th Cir. 2006).

While expressing a purported concern for public policy, however, none of the advantages of arbitration

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[3] Richard Epstein explains why the "mutuality argument" cannot be a legitimate basis for declaring a contract unconscionable:

> A could not complain if B decided not to make him any offer at all; why then is he entitled to complain if B decides to make him *better off* by now giving him a choice when before he had none? If A does not like B's offer, he can reject it; but to allow him to first accept the agreement and only thereafter to force B to work at a price which B finds unacceptable is to allow him to resort (with the aid of the state) to the very form of duress that on any theory is prohibited. There is no question of "dictation" of terms where B refuses to accept the terms desired by A. There is every question of dictation where A can repudiate his agreement with B and hold B to one to which B did not consent; and that element of dictation remains even if A is but a poor individual and B is a large and powerful corporation. To allow that to take place is to indeed countenance an "inequality of bargaining power" between A and B, with A having the legal advantage as he is given formal legal rights explicitly denied B.

Richard A. Epstein, *Unconscionability: A Critical Reappraisal*, 18 J.L. & Econ. 293, 297 (1975).

were even acknowledged by the California Supreme Court when it adopted the mutuality test in *Armendariz*, 24 Cal. 4th at 117, and announced that arbitration agreements must contain a "modicum of bilaterality." The effect was striking. In the first five years after *Armendariz*, more than two-thirds of the courts that invalidated arbitration provisions did so because the provisions lacked mutuality. Stephen A. Broome, *An Unconscionable Application of the Unconscionability Doctrine: How the California Courts are Circumventing the Federal Arbitration Act*, 3 Hastings Bus. L.J. 39, 50-51 (2006); *see also* Michael Schneidereit, Note, *A Cold Night: Unconscionability as a Defense to Mandatory Arbitration Clauses in Employment Agreements*, 55 Hastings L.J. 987, 1002 (2004) ("[I]n *Armendariz*, the court honed California unconscionability law into a weapon that could be used against mandatory arbitration agreements."); Paul Thomas, Note, *Conscionable Judging: A Case Study of California Courts' Grapple with Challenges to Mandatory Arbitration Agreements*, 62 Hastings L.J. 1065, 1083 tbl.1, 1084 (2011) (the vast majority of unconscionability cases decided between 2005 and 2008 by the California Courts of Appeal—89 out of 119—challenged arbitration agreements, confirming that courts "applying California law are most likely discriminating against arbitration agreements in a manner that is preempted by the interpretation of the FAA advanced by the Supreme Court.").

The now-discredited *Discover Bank* decision also employed a form of the *Armendariz* mutuality test to strike down class-arbitration waivers, not because the language of the agreement lacked mutuality, but because of the court's view of how neutral language

might be applied in future disputes. In the court's view:

> [C]lass action or arbitration waivers are indisputably one-sided. "Although styled as a mutual prohibition on representative or class actions, it is difficult to envision the circumstances under which the provision might negatively impact Discover [Bank], because credit card companies typically do not sue their customers in class action lawsuits."

Discover Bank v. Superior Court, 36 Cal. 4th 148, 161 (2005), *overruled by Concepcion*, 131 S. Ct. at 1753. Although some language in *Armendariz* suggests that lack of mutuality possibly could be justified by "business realities," *Armendariz*, 24 Cal. 4th at 117, California courts search in vain for a business reality sufficient to justify lack of mutuality in an arbitration agreement. Broome, 3 Hastings Bus. L.J. at 54 (citing Michael G. McGuinness & Adam J. Karr, *California's "Unique" Approach to Arbitration: Why This Road Less Traveled Will Make All the Difference on the Issue of Preemption Under the Federal Arbitration Act*, 2005 J. Disp. Resol. 61, 81 (2005)).[4] *See also* Thomas H. Riske, *No Exceptions: How the Legitimate Business Justification for Unconscionability Only Further*

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[4] Again demonstrating greater faithfulness to the Federal Arbitration Act than the California courts, some federal district courts, even when applying California law, will occasionally find that the mutuality requirement was met and uphold an arbitration agreement. *See Rutter v. Darden Rests., Inc.*, No. CV-08-6106, 2008 WL 4949043, *4-*9 (C.D. Cal. Nov. 18, 2008); *Ramirez-Baker v. Beazer Homes, Inc.*, 636 F. Supp. 2d 1008, 1021 (E.D. Cal. 2008).

Demonstrates California Courts' Disdain for Arbitration Agreements, 2008 J. Disp. Resol. 591, 602-04 (2008) (The supposed "business realities" exception to the mutuality test, which uses terminology associated with general contract law, but which has been factually impossible to successfully invoke, provides another illustration of how California courts hold arbitration agreements to a unique standard.). The mutuality test thus effectively functions as an immediate strike one of unconscionability.

Equating mutuality with unconscionability violates the FAA because the rule applies only—and adversely—to arbitration contracts. Outside the arbitration context, California courts do not demand mutuality either. *See Principal Mut. Life Ins. Co. v. Vars, Pave, McCord & Freedman*, 65 Cal. App. 4th 1469, 1488-89 (1998) (unilateral mortgage agreement upheld because "[w]here sufficient consideration is present, mutuality is not essential"); *Hillsman v. Sutter Cmty. Hosp.*, 153 Cal. App. 3d 743, 752 (1984) (upholding unilateral employment contract where consideration requirement is properly met; a "mutuality of obligation" is unnecessary). Thus, California's "mutuality" approach to determining substantive unconscionability in arbitration provisions differs from the standard used to analyze ordinary contractual provisions for unconscionability. This violates the FAA as much as the *Discover Bank* rule invalidated in *Concepcion*, and for the same reasons.[5]

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[5] Most jurisdictions reject a requirement of mutuality for arbitration agreements. *See, e.g.*, *Ex Parte McNaughton*, 728 So. 2d 592, 598 (Ala.), *cert. denied,* 528 U.S. 818 (1999) (A mutuality approach relies on the "uniqueness of the concept of arbitration," "assigns a suspect status to arbitration agreements," and therefore (continued...)

See Soto v. State Industrial Products, Inc., 642 F.3d 67, 76-77 (1st Cir. 2011) ("the FAA preempts Puerto Rico from imposing such a requirement applicable only to

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[5] (...continued)
"flies in the face of *Doctor's Associates*."); *Harris v. Green Tree Fin. Corp.*, 183 F.3d 173, 180 (3d Cir. 1999) ("[S]ubstantive federal law stands for the proposition that parties to an arbitration agreement need not equally bind each other with respect to an arbitration agreement if they have provided each other with consideration beyond the promise to arbitrate"); *In re Pate*, 198 B.R. 841, 844 (S.D. Ga. 1996) (same result under Georgia law); *Munoz v. Green Tree Fin. Corp.*, 542 S.E.2d 360, 365 (S.C. 2001) ("[T]he doctrine of mutuality of remedy does not apply here. An agreement providing for arbitration does not determine te *remedy* for a breach of contract but only the *forum* in which the remedy for the breach is determined."); *State ex rel. Vincent v. Schneider*, 194 S.W.3d 853, 859 (Mo. 2006) ("There is no reason to create a different mutuality rule in arbitration cases. Both parties to this contract exchanged consideration in this sale of a home. The contract will not be invalidated for lack of mutuality of obligation of the arbitration clause."); *Stenzel v. Dell, Inc.*, 870 A.2d 133, 144 (Me. 2005) ("[T]he agreement is not unconscionable because, even though the arbitration clause lacks mutuality of obligation, the underlying contract for the sale of Dell computers is supported by adequate consideration."); *In re Lyon Financial Servs., Inc.*, 257 S.W.3d 228, 233 (Tex. 2008); *Walther v. Sovereign Bank*, 386 Md. 412, 433 (Md. 2005); *McKenzie Check Advance of Miss., LLC v. Hardy*, 866 So. 2d 446, 453 (Miss. 2004). *See also* Susan Landrum, *Much Ado About Nothing?: What the Numbers Tell Us About How State Courts Apply the Unconscionability Doctrine to Arbitration Agreements*, 97 Marq. L. Rev. 751, 781, 785, 787 (2014) (study of 20 states, 10 of which reject the unconscionability doctrine entirely, three that accept the unconscionability doctrine across the board for all types of contracts; two states that are willing to consider unconscionability arguments; and four states (Missouri, Nevada, New Mexico, and Illinois) that are "very sympathetic to unconscionability arguments, but only if the challenged provision is part of an arbitration agreement." Montana has an aberrational approach that focuses on reasonable expectations rather than unconscionability. *Id.* at 801.

arbitration provisions"); *Southeastern Stud & Components, Inc. v. American Eagle Design Build Studios, LLC*, 588 F.3d 963, 967 (8th Cir. 2009) (citing Supreme Court cases holding that the FAA preempts state laws that invalidate arbitration contracts on grounds applicable only to arbitration contracts).

In contrast to most state courts, the *Armendariz* demand that arbitration contracts—but not other contracts—contain mutual, reciprocal provisions adversely affects arbitration contracts throughout California.

B. *Armendariz* Bootstraps the Lack of Mutuality to Invalidate Entire Arbitration Contracts

The *Armendariz* severance rule requires California courts to invalidate an arbitration contract if there are two unconscionable provisions. *See, e.g, Trivedi v. Curexo Tech. Corp*., 189 Cal. App. 4th 387, 398 (2010) ("At least two provisions were properly found to be substantively unconscionable, a circumstance considered by our Supreme Court to "permeate" the agreement with unconscionability."). Compounding the effect of this rule is that in many cases, one of the two "unconscionable" aspects of the contract is the "lack of mutuality" described above. The California courts demand that arbitration contracts—but not other contracts—have "mutual" provisions such that both parties stand in precise equivalence. A lack of mutuality is deemed unconscionable, and thus provides the first strike against an arbitration contract. *See* Arthur M. Kaufman and Ross M. Babbitt, *The Mutuality Doctrine in the Arbitration Agreements: The Elephant in the Road*, 22 Franchise L.J. 101, 104 (2002) ("Mutuality of

obligation is enjoying a different sort of renaissance in the arbitration context as a component of the unconscionability analysis.").

For example, in *Fitz v. NCR Corp.*, 118 Cal. App. 4th 702, 726-27 (2004), the arbitration agreement contained "two unlawful provisions: a limitation on discovery that does not provide the weaker party with sufficient opportunity to vindicate her claims, and a lack of mutuality whereby the stronger party has exempted from arbitration the very claims it is likely to bring against employees." The court concluded that this showed a systematic effort by the employer to impose arbitration on employee as inferior forum; and that, moreover, there was no single provision that could be stricken to remove the taint. *Id.* Similarly, in *Abramson v. Juniper Networks, Inc.*, 115 Cal. App. 4th 638, 666 (2004), the court held that there were two unconscionable terms in the arbitration agreement: an illegal cost-sharing provision and a lack of mutuality regarding arbitrable claims. The court held that the combination demonstrated that the agreement was "permeated with illegality and unconscionability." *Id.* In short, the court relied on the principle established in *Armendariz* that while "a wide variety of attributes may affect the determination of substantive unconscionability. . . . , the key factor is lack of mutuality."). *Id.* at 658.

It is well-established that there is "no such doctrine of complete mutuality under federal law." *Becker Autoradio U.S.A., Inc. v. Becker Autoradiowerk GmbH*, 585 F.2d 39, 47 n.15 (3d Cir. 1978). To the contrary, a contract may confer rights and obligations on one party that it does not confer on the other. Restatement (Second) of Contracts § 79 (1981) ("If the

requirement of consideration is met, there is no additional requirement of . . . equivalence in the values exchanged."). This principle applies in the context of arbitration agreements. *Harris v. Green Tree Fin. Corp.*, 183 F.3d 173, 180 (3d Cir. 1999) ("[P]arties to an arbitration agreement need not equally bind each other with respect to an arbitration agreement if they have provided each other with consideration beyond the promise to arbitrate."); *Michalski v. Circuit City Stores, Inc.*, 177 F.3d 634, 637 (7th Cir. 1999); *Johnson v. Circuit City Stores, Inc.*, 148 F.3d 373, 378 (4th Cir. 1998); *Doctor's Assocs., Inc. v. Distajo*, 66 F.3d 438, 451-53 (2nd Cir. 1995) (mutuality of obligation or remedy not required if arbitration agreement supported by consideration)).

Most state courts considering the issue also reject the mutuality requirement. For example, in *Dan Ryan Builders, Inc. v. Nelson*, the West Virginia Supreme Court surveyed treatises, journals, and cases from numerous jurisdictions and "conclude[d] that the formation of a contract with multiple clauses only requires consideration for the entire contract, and not for each individual clause." It further noted that "the majority of courts conclude that the parties need not have separate consideration for the arbitration clause, or equivalent, reciprocal duties to arbitrate, so long as the underlying contract as a whole is supported by valuable consideration." 230 W. Va. 281, 288-89 & n.10 (2012) (collecting cases). Similarly, the Missouri Supreme Court explained that the "mutuality of obligation" requirement is a "dead letter in contract law" and that there is "no reason to create a different mutuality rule in arbitration cases." *State ex rel. Vincent v. Schneider*, 194 S.W.3d 853, 859 (Mo. 2006). *See also Carter v. SSC Odin Operating Co., LLC*, 976

N.E.2d 344, 353 (Ill. 2012) (plaintiff's "promise to arbitrate, even if not met with a reciprocal promise to arbitrate by defendant, is nonetheless supported by consideration."); Richard A. Bales, *Contract Formation Issues in Employment Arbitration*, 44 Brandeis L.J. 415, 453 (2006) ("[M]utuality is not required so long as the employer has provided the employee with some other type of consideration. . . . [M]utuality problems are easy to avoid. The easiest way to ensure mutuality is to make the arbitration promises reciprocal . . . [or by] making arbitration part of a larger contract[.]")

California's outlier rule on mutuality in itself disadvantages arbitration contracts, and doubles the effect of the similarly adverse severability rule. By doing so, it ignores all public policies favoring arbitration. As the Missouri Supreme Court explained in *Baker v. Bristol Care, Inc.*, 450 S.W.3d 770, 787 (2014):

> [T]o find that there was no consideration for Ms. Baker's promise is to say that there was ***absolutely no*** benefit to Ms. Baker in being able to arbitrate whatever claims she may have against Bristol Care in the future **and** ***absolutely no*** cost to Bristol Care in obligating itself to that process and its results. These conclusions cannot be justified either by the fact that Ms. Baker has changed her mind about wanting to arbitrate her claims or by any lingering judicial hostility toward arbitration generally.

As this Court has recognized, there are multiple benefits to bilateral arbitration: "lower costs, greater efficiency and speed, and the ability to choose expert

adjudicators to resolve specialized disputes." *Stolt-Nielsen S.A. v. AnimalFeeds International Corp.*, 559 U.S. 662, 685 (2010) (citing *Gilmer v. Interstate/Johnson Lane Corp.*, 500 U.S. 20, 31 (1991); *Mitsubishi Motors Corp. v. Soler Chrysler-Plymouth, Inc.*, 473 U.S. 614, 628 (1985); *14 Penn Plaza LLC v. Pyett*, 556 U.S. 247, 257 (2009) ("Parties generally favor arbitration precisely because of the economics of dispute resolution.")) (additional citations omitted).

The *Armendariz* doctrines, combining a demand for mutuality and a uniquely narrow approach to severability, ignore all these benefits. The anti-arbitration rules established in *Armendariz* contravene the Federal Arbitration Act and the federal substantive law of arbitration.

CONCLUSION

The judgment of the Ninth Circuit Court of Appeals should be reversed, and this Court should explicitly abrogate the anti-arbitration doctrines established by the California Supreme Court in *Armendariz*.

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Respectfully submitted,

DEBORAH J. LA FETRA
Counsel of Record
Pacific Legal Foundation
930 G Street
Sacramento, California 95814
Telephone: (916) 419-7111
Facsimile: (916) 419-7747
E-mail: dlafetra@pacificlegal.org

Counsel for Amicus Curiae Pacific Legal Foundation