

No. 19-875

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IN THE  
*Supreme Court of the United States*

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OTO, L.L.C.,

*Petitioner,*

v.

KEN KHO;  
JULIE A. SU, CALIFORNIA LABOR COMMISSIONER,

*Respondents.*

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**On Petition For A Writ Of Certiorari  
To The Supreme Court Of California**

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**BRIEF OF THE CATO INSTITUTE  
AS *AMICUS CURIAE*  
IN SUPPORT OF PETITIONER**

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## **QUESTION PRESENTED**

Does the Federal Arbitration Act prohibit states from invalidating contracts on the ground that they require resolution of disputes in arbitration rather than in an administrative proceeding?

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## **INTEREST OF *AMICUS CURIAE*<sup>1</sup>**

The Cato Institute was established in 1977 as a nonpartisan public policy research foundation dedicated to advancing the principles of individual liberty, free markets, and limited government. Cato’s Center for Constitutional Studies was established in 1998 to help restore the principles of limited constitutional government that are the foundation of liberty. Toward those ends, Cato publishes books and studies, conducts conferences and forums, files *amicus* briefs, and produces the *Cato Supreme Court Review*.

This case concerns Cato because it implicates the fundamental principle that contracts between private parties should be enforced according to their terms without government interference.

### **INTRODUCTION AND SUMMARY OF ARGUMENT**

Congress enacted the Federal Arbitration Act (“FAA”) in 1925 “to overcome judicial hostility to arbitration agreements.” *Allied-Bruce Terminix Cos. v. Dobson*, 513 U.S. 265, 272 (1995). By providing that arbitration agreements “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, the FAA established that “arbitration is a

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<sup>1</sup> Pursuant to Rule 37.6, counsel for *amicus curiae* states that no counsel for a party authored this brief in whole or in part and no one other than the *amicus* and its counsel made a monetary contribution to fund the preparation or submission of this brief. Pursuant to Rule 37.2, counsel for *amicus curiae* states that counsel for Petitioner and Respondents received timely notice of intent to file this brief, and each has consented in writing to the filing of this brief.

matter of contract, and courts must enforce arbitration agreements according to their terms,” *Henry Schein, Inc. v. Archer & White Sales, Inc.*, 139 S. Ct. 524, 529 (2019).

Nearly a century later, courts across the country continue to treat arbitration agreements as a form of second-class contract that they will enforce only when doing so serves their interests and brush aside otherwise. Nowhere is this judicial hostility to arbitration more apparent or more flagrant than in California. For decades, California courts have stood in defiance of the FAA. And when this Court has intervened to remind them that they are bound by this federal statute—as it has done no fewer than five times, including three times in the past 12 years—California courts have responded by inventing new justifications for invalidating contracts calling for arbitration.

This tendency has only become more pronounced in recent years. After this Court struck down a California Supreme Court rule holding that class action waivers in consumer contracts are *per se* unconscionable, the California Supreme Court responded by recasting various forms of *relief* under California’s consumer-protection laws as “public” in nature and thus beyond the purview of the FAA. At the same time, California courts have stretched the facially neutral unconscionability doctrine beyond all recognition when an arbitration agreement is at issue. In fact, just last year the California Court of Appeal refused to enforce an arbitration agreement between a law firm and one of its partners who had a Ph.D. in biophysics, on the ground that the agreement was somehow unconscionable despite the sophistication of both parties. One would be forgiven for doubting whether

the same result would have obtained had the contract in question been anything other than a contract to arbitrate.

The decision below is the latest example of the refusal of California courts to enforce contracts that require the arbitration of disputes, and it illustrates how far astray those courts have gone in their quest to rid California of arbitration. The agreement here took care to ensure that all disputes would be arbitrated in a process that closely tracked ordinary civil litigation, including “full discovery,” “adherence to ‘all rules of pleading . . . [and] all rules of evidence,’” and decision “before a retired superior court judge.” Pet. App. 4a. And yet the California Supreme Court counterintuitively held that this contract was unconscionable on the ground that it required employees to forgo asserting their claims in an administrative proceeding providing *fewer* procedural protections than would be available in arbitration.

The implications of that decision reach far beyond the facts of this case and cut to the very heart of the freedom of contract. The California Supreme Court has created an irrational and arbitrary bar on the ability of employers and employees to agree to resolve disputes through arbitration. Although the decision below is just the most recent in a long line of cases in which California courts have flouted the FAA and this Court, it surely will not be the last.

This Court should grant certiorari and again reject the California Supreme Court’s latest attempt to evade the FAA.

## ARGUMENT

### **I. CALIFORNIA COURTS HAVE A LONG HISTORY OF REFUSING TO ENFORCE ARBITRATION AGREEMENTS, PROMPTING MULTIPLE REVERSALS FROM THIS COURT.**

That California courts are hostile to arbitration is no secret. Courts and commentators alike have documented the creativity and zeal with which courts in California have attempted to sidestep Congress's directive that arbitration agreements enjoy the same protection as any other contract. Despite this Court's vigorous enforcement of the FAA, California courts still have not gotten the message that they cannot apply a different set of rules to contracts calling for the arbitration of disputes.

#### **A. Judicial Hostility To Arbitration In California Is Well Documented.**

"California's legislature and courts have been among the most aggressive in seeking to limit arbitration." E. Gary Spitko, *Federal Arbitration Act Preemption of State Public-Policy-Based Employment Arbitration Doctrine: An Autopsy and Argument for Federal Oversight*, 20 Harv. Negot. L. Rev. 1, 4 (2015). And while there is no dispute that "[s]tates aside from California also have long" attempted to evade the FAA's mandate, "no other state has done so to the extent that California has." *Id.* at 5–6.

This hostility to arbitration—even as compared to other states that have similarly hesitated to fully em-

brace the practice—has drawn the attention of numerous courts within and without California.<sup>2</sup> It has also drawn the attention of litigants who, in the words of one federal judge in California, “have come to recognize ‘California courts’ open hostility to arbitration,” *Dominick’s Finer Foods v. Nat’l Constr. Servs., Inc.*, 2010 WL 891321, at \*5 (C.D. Cal. Mar. 9, 2010), with uncertain implications for those litigants’ faith in the neutrality of the courts.

Of course, California courts have not generally targeted arbitration explicitly. While courts before the enactment of the FAA would not hide their antipathy for arbitration, in the wake of that statute’s enactment—and particularly since this Court began to actively police compliance with the FAA in recent decades—courts have resorted to subtler means of achieving the same result. In particular, California courts have dressed up their hostility to arbitration in the guise of generally applicable contract defenses—primarily (but not exclusively) the doctrine of unconscionability.

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<sup>2</sup> See, e.g., *Oce Bus. Servs., Inc. v. Christensen*, 803 N.Y.S.2d 19, at \*3 n.4 (2005) (unpublished) (“California is quite hostile to the enforcement of pre-dispute agreements to arbitrate employment agreements, as compared to New York, which is far more supportive of arbitration.”); *Carter v. Countrywide Credit Indus., Inc.*, 362 F.3d 294, 301 n.5 (5th Cir. 2004) (“California law and Texas law differ significantly, with the former being more hostile to the enforcement of arbitration agreements than the latter.”); *Nagrampa v. MailCoups, Inc.*, 469 F.3d 1257, 1313 (9th Cir. 2006) (en banc) (Kozinski, J., dissenting) (observing that “California courts have shown a lamentable tendency to hold the arbitration clauses in [form] contracts unenforceable,” reflecting “a disturbing trend of judicial hostility” to such contracts).

But while the FAA provides that a court may decline to enforce an arbitration agreement “upon such grounds as exist at law or in equity for the revocation of any contract,” 9 U.S.C. § 2, this Court has made clear that the FAA not only “preempts any state rule discriminating on its face against arbitration,” but also “any rule that covertly accomplishes the same objective,” *Kindred Nursing Ctrs. Ltd. P’ship v. Clark*, 137 S. Ct. 1421, 1426 (2017). That is precisely what California courts have done, applying the ostensibly neutral unconscionability defense in a much more sweeping manner when a contract calls for arbitration.

As one commentator has observed, although traditionally “judicial decisions grounded on unconscionability doctrine were few and far between,” “[w]ith the expanded use of binding arbitration provisions in consumer contracts, . . . unconscionability doctrine came into vogue as a means of curtailing perceived abuses.” Thomas J. Stipanowich, *The Third Arbitration Trilogy: Stolt-Nielsen, Rent-A-Center, Concepcion and the Future of American Arbitration*, 22 *Am. Rev. Int’l Arb.* 323, 352 (2011). And while the increased reliance on unconscionability as a means of circumventing the FAA has been widespread, “the courts of some states, notably California, have been considerably more energetic in developing unconscionability doctrine than others.” *Id.* at 353.

Empirical evidence confirms that California has developed an increasingly hostile—and increasingly circumspect—arbitration jurisprudence. As one study of California Court of Appeal decisions between 1982 and 2006 found, “unconscionability challenges suc-

ceeded in about fifty-eight percent of cases in the arbitration context,” whereas “[i]n the non-arbitration context . . . unconscionability challenges succeeded only eleven percent of the time.” 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, 48 (2006). And these results are not a one-off. On the contrary, a review of 119 cases decided by the California Court of Appeal between 2005 and 2008 concluded that the court “found in favor of unconscionability at a noticeably higher rate in arbitration cases, as compared to other cases”—50.6 percent compared to just 16.7 percent. Paul Thomas, *Conscionable Judging: A Case Study of California Courts’ Grapple with Challenges to Mandatory Arbitration Agreements*, 62 *Hastings L.J.* 1065, 1083 (2011).

This disparity is not attributable to any intrinsic difference in arbitration agreements as compared to other types of contracts. In fact, in the early 1980s “[t]he rate of unconscionability findings by type of contract, arbitration or nonarbitration, showed little variation,” with courts holding “12.5% of the arbitration agreements, as compared to 15.2% of other types of contracts, unconscionable.” Susan Randall, *Judicial Attitudes Toward Arbitration and the Resurgence of Unconscionability*, 52 *Buff. L. Rev.* 185, 196 (2004). Just 20 years later, however, “[c]ourts found 50.3% of the arbitration agreements unconscionable, as op-

posed to 25.6% of other types of contracts,” with “federal and state courts in California decid[ing] a significant number of these cases.” *Id.* at 194–95.<sup>3</sup>

This overwhelming evidence admits of only one conclusion: “California courts continue to view arbitration agreements as a ‘lesser caste’ of contract provision to be ignored whenever the court suspects one party may be disadvantaged by having to arbitrate its claims.” Broome, 3 Hastings Bus. L.J. at 67 (footnote omitted). And while they continue to mask their decisions in the language of unconscionability, “[t]hrough both empirical and substantive analysis . . . the cloak of the ‘generally applicable’ contract defense of unconscionability is removed, and these unique standards and requirements are revealed for what they really are: manifestations of the California courts’ ingrained bias against arbitration as an alternative to the judicial forum.” *Id.* at 68.

To be sure, California is not alone in this practice. But “California state courts are clearly playing a leading role” in a widespread resistance to Congressional policy and this Court’s precedents, with a full one-third of state-court cases invalidating an arbitration

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<sup>3</sup> See also Charles L. Knapp, *Blowing the Whistle on Mandatory Arbitration: Unconscionability as a Signaling Device*, 46 San Diego L. Rev. 609, 622–23 (2009) (“Over the entire period from 1990 through 2008, the annual number of nonarbitration cases in which an unconscionability claim was upheld remained remarkably constant at only a handful—never more than half a dozen per year. By contrast, not only did the annual number of unconscionability claims in arbitration cases show a consistent increase beginning in 1997, their relative rate of success also increased over the first years of the new century.” (footnote omitted)).

agreement on unconscionability grounds coming from California. Knapp, 46 San Diego L. Rev. at 623–24. For this reason, California decisions striking down arbitration agreements on unconscionability grounds—as in this case—merit special attention from this Court.

**B. This Court Has Repeatedly Rejected California’s Hostility To Arbitration.**

This Court is no stranger to California’s insistence that arbitration agreements are a form of second-class contract. On the contrary, it has spent nearly 40 years reviewing—and reversing—California decisions refusing to enforce arbitration agreements on increasingly inventive grounds.<sup>4</sup> This Court’s interventions reached a crescendo in the past decade.

First on the docket was the anti-arbitration rule that the California Supreme Court created in *Discover Bank v. Superior Court*, 113 P.3d 1100 (Cal. 2005).

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<sup>4</sup> See, e.g., *Southland Corp. v. Keating*, 465 U.S. 1, 10 (1984) (concluding that “[t]he California Supreme Court[s] interpret[ation of a State] statute to require judicial consideration of claims brought under the State statute . . . directly conflicts with § 2 of the Federal Arbitration Act”); *Perry v. Thomas*, 482 U.S. 483, 491 (1987) (holding that “[t]he oblique reference to the Federal Arbitration Act in footnote 15 of [the precedent relied on by the California Court of Appeal] cannot fairly be read as a definitive holding” that the FAA does not require arbitration of claims under California Labor Code § 229); *Preston v. Ferrer*, 552 U.S. 346, 359 (2008) (concluding that “[w]hen parties agree to arbitrate all questions arising under a contract, the FAA supersedes state laws lodging primary jurisdiction in another forum, whether judicial or administrative,” and thus “disapprov[ing] the distinction between judicial and administrative proceedings drawn by Ferrer and adopted by the appeal court”).

*Discover Bank* held that “class action waivers in consumer contracts of adhesion are unenforceable.” *Id.* at 1103. In the California Supreme Court’s view, such a rule did not conflict with the FAA because “the principle that class action waivers are, under certain circumstances, unconscionable as unlawfully exculpatory is a principle of California law that does not specifically apply to arbitration agreements, but to contracts generally,” *id.* at 1112—even if it “may be the case that arbitration becomes a less desirable forum . . . if the arbitration must be conducted in a classwide manner,” *id.* at 1117.

This Court did not just strike down the rule articulated by the California Supreme Court in *Discover Bank*; it repudiated its reasoning root and branch. Noting that “the judicial hostility towards arbitration that prompted the FAA had manifested in ‘a great variety’ of ‘devices and formulas’ declaring arbitration against public policy,” the Court confirmed that “the FAA’s pre-emptive effect might extend even to grounds traditionally thought to exist ‘at law or in equity for the revocation of any contract’” when those grounds have “been applied in a fashion that disfavors arbitration.” *AT&T Mobility LLC v. Concepcion*, 563 U.S. 333, 341–42 (2011). In support of this proposition, the Court cited its prior decision in *Perry*, which announced the very same principle more than 20 years earlier in the course of reversing a *different* California decision refusing enforcement of an arbitration agreement. *Id.* at 341. Small wonder, then, that the Court considered it “worth noting that California’s courts have been more likely to hold contracts to arbitrate unconscionable than other contracts.” *Id.* at 342.

While other courts may have been chastened by such a reversal, California courts were emboldened. Less than three years after *Concepcion*, the California Court of Appeal invalidated a different arbitration agreement under the very same *Discover Bank* rule that this Court had recently held was invalid under the FAA. Again reversing, this Court saw fit to begin its opinion by reviewing the fundamental proposition that “lower courts must follow this Court’s holding in *Concepcion*” notwithstanding “[t]he fact that *Concepcion* was a closely divided case, resulting in a decision from which four Justices dissented.” *DirecTV, Inc. v. Imburgia*, 136 S. Ct. 463, 468 (2015).

In all, this Court has reviewed and reversed anti-arbitration decisions of California courts on five separate occasions, each time concluding that they had used ostensibly neutral state-law principles in a manner that failed to provide equal treatment to contracts calling for arbitration. Yet California courts have made it abundantly clear that they will continue crafting new anti-arbitration rules.

## **II. NOTWITHSTANDING THIS COURT’S DECISIONS, CALIFORNIA COURTS CONTINUE TO INVENT NEW WAYS TO FRUSTRATE THE ENFORCEMENT OF ARBITRATION AGREEMENTS.**

Although “a majority of the U.S. Supreme Court’s landmark FAA preemption cases have arisen in the context of challenges to California statutory or case law . . . , especially in the context of employment arbitration agreements, the California courts have remained undeterred by the mere Supremacy Clause.” Spitko, 20 Harv. Negot. L. Rev. at 4–5. They have instead developed a jurisprudence “characterized by its

creativity if not willful blindness to U.S. Supreme Court precedents,” with each new doctrinal innovation “of dubious validity from a preemption standpoint.” *Id.* at 5.

The state of the law in California has reached such a dismal condition that even *lawyers* can escape agreements to arbitrate on the grounds of unconscionability. In *Ramos v. Superior Court*, 28 Cal. App. 5th 1042 (2018), the California Court of Appeal denied a motion filed by the law firm Winston & Strawn to compel arbitration of a case filed by one of its partners. The court acknowledged that the partner was “an experienced litigator and patent practitioner with a doctorate in biophysics,” *id.* at 1046, who “had an established career in intellectual property law,” had “previously worked as a partner at two other law firms,” and was “admitted as a solicitor in the United Kingdom,” *id.* at 1047. Nevertheless, the court concluded that “the arbitration agreement [wa]s procedurally unconscionable” because the partner “had no opportunity to negotiate or amend any term of th[e] agreement” and “was presented with the Partnership Agreement the day after she began work and was told to return it, signed, within 30 days.” *Id.* at 1064. At the same time, the court found the arbitration agreement substantively unconscionable because it required the partner to pay her own attorney fees and split the arbitration costs with her employer, limited the arbitrator’s authority to award certain relief, and contained a confidentiality provision. *See id.* at 1064–65.

It is difficult to imagine a non-arbitration contract between such sophisticated parties that would fail un-

der such circumstances. And if a partner at a prestigious law firm with a Ph.D. in biophysics cannot be held to her agreement to arbitrate, then nobody can.

At the same time that they have been stretching unconscionability in the arbitration context beyond all recognition, California courts have added a new epicycle to their “generally applicable defense” framework to circumvent *Concepcion*. In particular, these courts have recast entire categories of state-law claims as implicating *public* rights, such that they fall outside the scope of the FAA altogether.

For example, the California Supreme Court has refused to compel individual arbitration of “representative” claims under the California Labor Code’s Private Attorneys General Act (“PAGA”), reasoning that such claims “directly enforce *the state’s* interest in penalizing and deterring employers who violate California’s labor laws” and thus are not governed by “the United States Supreme Court’s FAA jurisprudence,” which “consists entirely of disputes involving the parties’ *own* rights and obligations, not the rights of a public enforcement agency.” *Iskanian v. CLS Transp. L.A., LLC*, 327 P.3d 129, 150, 152 (Cal. 2014).

The California Supreme Court has employed similar reasoning in refusing to compel individual arbitration of claims for “public injunctive relief” under California’s Unfair Competition Law, Consumer Legal Remedies Act, and False Advertising Law, concluding that such relief is “a *substantive statutory remedy* that the Legislature . . . has made available” to plaintiffs rather than “a *procedural device*” like a class action, and thus has nothing to do with *Concepcion*. *McGill v. Citibank, N.A.*, 393 P.3d 85, 97 (Cal. 2017).

In short, California courts have become increasingly assertive in their hostility to arbitration in the five years since *DirecTV*. This assertiveness reached its culmination in the decision below.

**III. THIS COURT SHOULD GRANT CERTIORARI TO REJECT THE CALIFORNIA SUPREME COURT'S LATEST ATTEMPT TO UNDERMINE THE FREEDOM OF PARTIES TO ENTER INTO ARBITRATION AGREEMENTS.**

The California Supreme Court's decision in this case exemplifies and extends its post-*Concepcion* assault on arbitration by applying an increasingly elastic unconscionability doctrine in a manner that would never apply to non-arbitration agreements. Worse still, the decision creates a near de facto categorical exemption from arbitration for an entire category of California employment claims—namely, those that would otherwise be eligible for a so-called “Berman” administrative hearing.<sup>5</sup>

As has become its practice, the California Supreme Court insists that it has done no such thing, and that its decision here is simply the result of a faithful application of neutral unconscionability principles to the particular facts at hand. Although it

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<sup>5</sup> A Berman hearing is a streamlined administrative procedure before the California Labor Commissioner in which certain employment claims, including claims for unpaid wages, may be litigated. See Cal. Lab. Code § 98 *et seq.*; see also Pet. App. 7a–10a. Although an employee has the choice whether to file a complaint with the Labor Commissioner or proceed directly to court, the Labor Commissioner's decision is subject to *de novo* review in the California Superior Court. Cal. Lab. Code § 98.2(a).

found the agreement at issue to be procedurally unconscionable, the court emphasized that “an unconscionability analysis must be sensitive to context,” and that “the same contract terms might pass muster under less coercive circumstances.” Pet. App. 30a–31a. And although it found the arbitration process to be substantively unconscionable, the court reasoned that “we have simply evaluated the bargain at issue” and “[w]e have not said that *no* arbitration could provide an appropriate forum for resolution of Kho’s wage claim, but only that *this particular* arbitral process . . . is unconscionable.” *Id.* at 33a.

But if an arbitration agreement like this one cannot pass muster under California law, it is unclear what contract can. The terms of the agreement that the California Supreme Court found “overly harsh,” “unduly oppressive,” and “so one-sided as to shock the conscience” under California’s substantive unconscionability analysis, Pet. App. 20a (some quotation marks omitted), provide for the *very same* protections that define everyday civil litigation, *id.* at 25a (criticizing “the arbitration provided for here” because it “incorporates the intricacies of civil litigation”). According to the California Supreme Court, an arbitration agreement that provides *the same* protections as civil litigation—and not some streamlined procedures comparable to those in a Berman hearing—is *per se* unfair.

Underlying the California Supreme Court’s decision is a subtler yet more pernicious skepticism of the foundational premise of the freedom of contract: mutual exchange. “The FAA reflects the fundamental principle that arbitration is a matter of contract,” and

thus “requires courts to enforce [arbitration agreements] according to their terms.” *Rent-A-Ctr., W., Inc. v. Jackson*, 561 U.S. 63, 67 (2010). And arbitration agreements, like any contract, necessarily entail each party forgoing something of value in order to gain something of greater value from the other party.

Here, just such an exchange took place. While Mr. Kho agreed to resolve this dispute according to the normal rules of civil litigation rather than through the streamlined procedures afforded in a Berman hearing—as he was free to do in the absence of an arbitration agreement—OTO agreed to submit itself to these very same rules with respect to *all other* claims Mr. Kho might bring against it. There is every reason to believe that employees like Mr. Kho would consider the benefits of this trade-off well worth the cost. After all, Berman hearings are available only for a subset of employment claims, whereas the arbitration agreement covers a wide range of *other* claims where the enhanced procedures available in civil litigation might prove advantageous to employees as compared to the more streamlined procedures typically afforded in arbitration.

The California Supreme Court, however, substituted its own judgment concerning the equities of this exchange for that of the parties. In its view, the arbitration agreement “was sufficiently one-sided as to render [it] unenforceable” because “Kho surrendered the full panoply of Berman procedures and assistance” while “[w]hat he got in return was access to a formal and highly structured arbitration process that closely resembled civil litigation *if* he could figure out how to avail himself of its benefits and avoid its pitfalls.” Pet. App. 31a. But as explained above, that was not *all* he

got; only by narrowly focusing on the arbitration agreement's application to claims that could be asserted in a Berman hearing could the bargain ever appear "one-sided."

In fact, it is the decision below that requires a one-sided bargain—albeit one that would redound solely to the benefit of employees like Mr. Kho. By holding that an arbitration agreement may be enforced with respect to claims subject to a Berman hearing only where it "provide[s] in exchange an accessible and affordable forum for resolving wage disputes," Pet. App. 26a (emphasis omitted), the California Supreme Court established that administrative process as an inflexible baseline from which an arbitration agreement may deviate in favor of only one party.

The effect of this rule is plain. When parties are denied the opportunity to engage in a mutual exchange for their shared benefit, there is no place for contract. By precluding parties from negotiating the methods of arbitrating employment claims like those here, the California Supreme Court has effectively closed off the possibility that any arbitration agreement will address those claims. That this discrimination is accomplished indirectly by a manipulation of contract law doctrines rather than through an outright ban makes no difference—either approach violates the FAA.

**CONCLUSION**

For the foregoing reasons, the petition for a writ of certiorari should be granted.

Respectfully submitted.

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