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March 11, 2014

Supreme Court of California
350 McAllister Street
San Francisco, CA 94102-4797

Re: *Sanchez v. Valencia Holding Co., LLC*
No. S199119

Response to Request for Supplemental Brief

Dear Honorable Justices:

In response to this Court's February 19, 2014 request for supplemental briefs addressing substantive unconscionability, Respondent Gil Sanchez submits the following letter brief:

I. Introduction

This case will set the standard for how far businesses can go in depriving consumers from access to fair and impartial resolution of disputes when using adhesive, highly procedurally unconscionable form contracts. When businesses are sued for violating the law by consumers, how unfair can the business make the dispute resolution process? Setting aside the underlying unfairness that businesses can deprive their customers access to the judicial system, how stacked a process can businesses create in their favor? The business world is watching this case so the drafters of their adhesive contracts can create dispute resolution systems that give the businesses as many advantages as possible and deprive consumers of as many rights as possible.

Under the Court's current formulations, businesses will seek to draft arbitration clauses that are favorable, just not "unreasonably favorable." They will draft clauses that

are one-sided, just not "unfairly one-sided." They will draft clauses that are harsh and oppressive, just not "overly harsh" or "unduly oppressive." Finally, businesses will just throw out all consumer rights completely if they can draft arbitration clauses that blatantly cheat consumers and create unfair processes so long as the process does not "shock the conscience." All of those clauses will erode consumer rights. And businesses will draft these clauses, put them in the fine print on the back of adhesive contracts, and then argue that if they went too far on any provision then just the egregious provisions should be stricken and the remainder of the agreement enforced.

This Court's description of the test for substantive unconscionability affects all consumers, not just Gil Sanchez. It affects all businesses that use form contracts of adhesion, not just the automotive industry. And whatever test this Court creates is likely to simply lead to more litigation as businesses seek to find out just how far they can go in drafting the arbitration clauses they stick in their adhesive contracts.

In *AT&T Mobility v Concepcion* (2011) 131 S.Ct. 1740, the United States Supreme Court enforced an arbitration clause in an adhesive contract for the sale and servicing of cellular telephones. The Supreme Court described the arbitration clause designed by AT&T, which included a class action waiver, as follows:

> The revised agreement provides that customers may initiate dispute proceedings by completing a one-page Notice of Dispute form available on AT&T's Web site. AT&T may then offer to settle the claim; if it does not, or if the dispute is not resolved within 30 days, the customer may invoke arbitration by filing a separate Demand for Arbitration, also available on AT&T's Web site. In the event the parties proceed to arbitration, the agreement specifies that AT&T must pay all costs for nonfrivolous claims; that arbitration must take place in the county in which the customer is billed; that, for claims of $10,000 or less, the customer may choose whether the arbitration proceeds in person, by telephone, or based only on submissions; that either party may bring a claim in small claims court in lieu of arbitration; and that the arbitrator may award any form of individual relief, including injunctions and presumably punitive damages. The agreement, moreover, denies AT&T any ability to seek reimbursement of its attorney's fees, and, in the event that a customer receives an arbitration award greater than AT&T's last written settlement offer, requires AT&T to

> pay a $ 7,500 minimum recovery and twice the amount of the claimant's attorney's fees.

(131 S.Ct. at 1744.)

While the issue before the United States Supreme Court was whether this Court's *Discover Bank* test applicable to class action waivers was an impermissible obstacle to the accomplishment of the FAA's objectives, Respondent believes the contents of AT&T's arbitration clause can provide this Court guidance in setting a test for whether an arbitration clause in an adhesion contract is substantively unconscionable.

Should the Court use any of the five formulations in describing substantive unconscionability identified in its invitation for this letter brief? No. Are there terms the Court should not use? Yes – all of the terms from the existing formulations create subjective tests leading to inconsistent results. Is there a formulation not identified in the invitation that should be used? Yes. Mr. Sanchez submits the test for substantive unconscionability in consumer form adhesion contracts should be the following two part test applicable to all terms in consumer adhesion contracts: (1) are the terms in question within the reasonable expectations of the consumer given the nature of the transaction?; (2) would a reasonable consumer, if he or she had the opportunity to accept or reject the terms, accept the terms? If the answer to either question is no, then the term in question should not be enforced. Only if the answer to both questions is yes should the term be in question. Using a reasonable consumer standard, instead of subjective adjectives, should provide for uniformity in this area of the law.

II. The Current Formulations Don't Work For Consumer Adhesion Contracts

Mr. Sanchez's case involves the enforcement of an arbitration clause on the back of the form contract used to purchase an automobile. The California New Car Dealers Association, in requesting this Court grant review of this case, stated "the arbitration clause held to be unconscionable in this case is used by a large majority of the CNCDA's

members and governs several million purchase transactions." (January 25, 2012 letter from John F. Querio to Supreme Court, at 2.) In addition to Mr. Sanchez's case, currently pending before this Court are eight other cases involving either the same contract, or a slightly modified version of the contract: *Buzenes v. Nuvell Financial Services*, No. S200376; *Caron v. Mercedes-Benz Financial Services USA*, No. S205263; *Goodridge v. KDF Automotive Group*, No. S206153; *Flores v. West Covina Auto Group*, No. S208716; *Natalini v. Import Motors, Inc.*, No. S209324; *Vasquez v. Greene Motors*, No. S210439; *Vargas v. SAI Monrovia B*, No. S212033; and *Gonzalez v. Metro Nissan of Redlands*, Case No. S214121.) Four of the cases, like the Second District in this case, found the arbitration clause both procedurally and substantively unconscionable (*Buzenes*, *Goodridge*, *Natalini*, and *Vargas*), three of the cases found the clause procedurally, but not substantively, unconscionable (*Flores*, *Vasquez*, and *Gonzalez*), and one did not address the issue (*Caron*).

A primary flaw with the various formulations utilized by this Court in the past is that this case involves a highly procedurally unconscionable arbitration clause. The test for unconscionability involves both a procedural and substantive element – "the more substantively oppressive the contract term, the less evidence of procedural unconscionability is required to come to the conclusion that the term is unenforceable, and vice versa." (*Armendariz v. Foundation Health Psychcare Services, Inc.* (2000) 24 Cal.4th 83, 114.) In an adhesion contract, where the seller does not show the consumer the back of the contract containing the arbitration clause, never discussed arbitration with the consumer, and buries the only reference to arbitration on the front of the contract in an unsigned portion of the contract, there is a high degree of procedural unconscionability. How does a consumer then meet his or her burden to provide "less evidence" of "unreasonably favorable," "unfairly one-sided," "overly harsh," or "unduly

oppressive" terms? Is the same term of a contract more or less substantively unconscionable based on how much procedural unconscionability was present?

The purpose of the FAA is to "ensure that private arbitration agreements are enforced according to their terms." (*AT&T Mobility*, 131 S.Ct at 1748 (citation omitted).) That purpose is premised on the legal fiction the parties agreed to the terms at issue. "The point of affording parties discretion in designing arbitration processes is to allow for efficient, streamlined procedures tailored to the type of dispute." (*Id.*, at 1749.) The pre-printed language in adhesion contracts is not negotiated. It is not "agreed to" by the consumer. It was not designed by the parties. The consumer did not have any discretion in creating the process. A pre-printed adhesion contract has language mandated by the more powerful party who requires the use of the form contract – consumers can take it or leave it. When those terms are forced on consumers, not shown to consumers, and not subject to negotiation, businesses cannot be given carte blanche to trample on consumer rights. The unconscionability defense, and the defenses available to enforcement of terms in contracts of adhesion, exist to prevent this overreaching.

The problems with the current formulations in describing the test for substantive unconscionability are best illustrated by the *Goodridge* and *Flores* cases. The Fourth District, in *Goodridge*, described the test for substantive unconscionability as follows:

> Substantive unconscionability focuses on whether the provision is overly harsh or one-sided and is shown if the disputed provision of the contract falls outside the 'reasonable expectations' of the nondrafting party or is 'unduly oppressive.' [Citations.] Some courts have imposed a higher standard: the terms must be "so one-sided as to *shock the conscience*."

(*Goodridge v. KDF Automotive Group, Inc.* (2012) 147 Cal.Rptr.3d 16, 26 (citation omitted) *review granted and opinion superseded*, (Cal. 2012) 150 Cal.Rptr.3d 501.)

The Fourth District then found substantively unconscionable the same provisions in the arbitration clause that the Second District did in *Sanchez*.

Post-*Pinnacle*, in *Flores*, a different panel of the Second District described the test for substantive unconscionability as follows:

> Substantive unconscionability pertains to the fairness of an agreement's actual terms and to assessments of whether they are overly harsh or one-sided. A contract term is not substantively unconscionable when it merely gives one side a greater benefit; rather, the term must be 'so one-sided as to "shock the conscience"'.

(*Flores v. West Covina Auto Group* (Cal. Ct. App. 2013) 151 Cal.Rptr.3d 481, 501-02 (citations omitted) *review granted and opinion superseded*, (Cal. 2013) 154 Cal.Rptr.3d 651.) Thus, the test was described in substantially similar terms.

Nonetheless, the Second District in *Flores* reached the opposite conclusion as the panel in this case and the Fourth District in *Goodridge*, finding none of the terms in dispute shocked the conscience or were unduly harsh or one-sided.

When the same contract is subject to the same test, the results should be the same, not different. If courts are reaching different results applying the same test, as they are with the test for substantive unconscionability, there is a problem with the test. The problem with the current test lies with the adjectives and modifiers. When a test uses words like "unduly," "unfairly," "unreasonably," "unfavorably," or "so one-sided as to shock the conscience," politics come into play. What one court considers "unreasonably favorable," another may consider just "favorable." What is "overly harsh" or "unduly oppressive" to some is just "harsh" or "oppressive" to others. There is no way to say a court is right or wrong in reaching these conclusions because there is so much leeway in the test.

The "shock the conscience" formulation is no better. In today's world, does anything really "shock the conscience" anymore? Would it really "shock" anyone's conscience to know what terms businesses try to put in mandatory arbitration clauses found in adhesion contracts? Would it really shock someone to learn a business tried to take away remedies from a customer and create a process that gave it advantages over the

consumer? Maybe some of the terms would mildly surprise you to learn, but actually "shock" your conscience? No. "Shock the conscience" is an unattainable standard. When our country was formed, slavery was legal – businesses could literally own their "employees." Social mores changed, a war was fought, and slavery was abolished. What "shocks the conscience" now was permissible under the Constitution when our nation was established. Like the other current terms used to describe substantive unconscionability, "shocks the conscience" leads to inconsistent results.

The protection of consumers falls on the Legislature to craft laws to protect them, and for courts to enforce those laws. Businesses now seek to skirt those protections by abolishing their customers' access to the judiciary and forcing dispute resolution into processes weighted in their favor that they control and pay for. That is why the test for substantive unconscionability in consumer adhesion contracts needs a new formulation that protects consumers and allows for fair resolution of disputes.

III. The Test Should Be A Reasonable Consumer Test

In the invitation for this letter brief, the Court identified five different formulations or terms used to describe what makes a contract substantively unconscionable: (1) "unreasonably favorable;" (2) "so one-sided to shock the conscience;" (3) "unfairly one-sided;" (4) "overly harsh;" and (5) "unduly oppressive." The "unreasonably favorable" language came from *Sonic-Calabasas A, Inc. v. Moreno* (2013) 57 Cal.4th 1109, 1145, a case involving an arbitration clause in an employment agreement. The "so one-sided to shock the conscience" language is from *Pinnacle Museum Tower Assn. v. Pinnacle Market Development* (2012) 55 Cal.4th 223, 246, involving an arbitration clause in CC&Rs. The "unfairly one-sided" language is from *Little v. Auto Stiegler, Inc.* (2003) 29 Cal.4th 1064, 1071-1072, evaluating an arbitration clause in an employment agreement. "Overly harsh," from *Armendariz v. Foundation Health Psychare Services, Inc.* (2000) 24 Cal.4th 83, 114, also involved an arbitration clause in an employment

agreement. Finally, *Perdue v. Crocker National Bank* (1985) 38 Cal.3d 913, 925, the source of the "unduly oppressive" formulation, is the only one of the cases cited that did not involve an arbitration agreement, but rather whether the price a bank charged its customers for processing NSF checks was unconscionable.

The United States Supreme Court has warned that state-law defenses cannot "stand as an obstacle to the accomplishment of the FAA's objectives," and the purpose of the FAA is "to ensure that private arbitration agreements are enforced according to their terms." (*AT&T Mobility*, 131 S.Ct. at 1748 (citations omitted).) However, the United States Supreme Court also noted "States remain free to take steps addressing the concerns that attend contracts of adhesion ...'" (*Id.*, at 1750, n. 6.) Therefore, Mr. Sanchez focuses on the analysis from *Perdue* for guidance since it involved an adhesion contract but not an arbitration clause.

In *Perdue* a consumer sued his bank, alleging it was unconscionable to charge $6 to process an NSF check when the cost to the bank was $0.30. (38 Cal.3d at 924-926.) The Court set forth the tests for enforcement of terms in adhesion contracts:

> "Generally speaking," we explained, "there are two judicially imposed limitations on the enforcement of adhesion contracts or provisions thereof. The first is that such a contract or provision which does not fall within the reasonable expectations of the weaker or 'adhering' party will not be enforced against him. [Citations.] The second - a principle of equity applicable to all contracts generally - is that a contract or provision, even if consistent with the reasonable expectations of the parties, will be denied enforcement if, considered in its context, it is unduly oppressive or 'unconscionable'."

(*Perdue*, 38 Cal.3d at 925 (quoting *Graham v. Scissor-Tail, Inc.* (1981) 28 Cal.3d 807, 819-820).) Although *Graham* involved an arbitration clause, the test it created was applicable to all terms in adhesion contracts.

Sometime in the last 33 years, the *Graham* two-prong test was corrupted and lost. At some point, it no longer mattered whether an arbitration clause in a consumer adhesion contract fell within the reasonable expectations of consumers. Perhaps it was in 1993, when a business argued "that arbitration has become such a common means of dispute resolution that it must be considered within the reasonable expectation of the borrowers." (*Patterson v. ITT Consumer Financial Corp.* (1993) 14 Cal.App.4th 1659, 1665.) Somehow, that argument turned to fact over the following 20 years: "arbitration is a common means of dispute resolution in this day and age and cannot fairly be said to defeat the reasonable expectations of consumers. (*Patterson v. ITT Consumer Financial Corp.* (1993) 14 Cal.App.4th 1659, 1665, 18 Cal.Rptr.2d 563 [recognizing arbitration is within the reasonable expectation of most consumers].)" (*Flores*, 151 Cal.Rptr.3d at 501 *review granted and opinion superseded*, (Cal. 2013) 154 Cal.Rptr.3d 651.) It wasn't a fact in 1993, and it is not a fact now. There was no evidence in *Patterson*, *Flores*, or here, that any consumer reasonably expects an arbitration clause in their adhesion contract to purchase a good. The inclusion of an arbitration clause in an adhesion contract may be within the reasonable expectations of lawyers and judges, but not the average, reasonable consumer.[1]

In *Patterson*, the Court of Appeal responded to the business's argument by stating "[w]hile arbitration per se may be within the reasonable expectation of most consumers,

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[1] The Consumer Financial Protection Bureau, which is investigating whether to ban mandatory arbitration clauses in consumer adhesion contracts, is in the process of conducting a study to determine consumer familiarity with arbitration clauses. (*See* Consumer Financial Protection Bureau, Arbitration Study Preliminary Results, released December 13, 2013.)

it is much more difficult to believe that arbitration in Minnesota would be within the reasonable expectation of California consumers." (14 Cal.App.4th at 1665.) The *Patterson* court did not conclude arbitration *was* a reasonable expectation of most consumers, it said it "may be," and even if it was that expectation didn't save the terms of the arbitration clause before it. Here, Mr. Sanchez testified he "had no reason to suspect that hidden on the back of the contracts that told me how much the vehicle cost and how much my monthly payments would be was a section that prohibited me from being able to sue the Dealership in court if I had a problem." (Appellant's Appendix, Vol. II, Tab 11, 0357-0358 (Paragraph 4).) Mr. Sanchez also testified "Prior to the filing of the Dealership's Motion to Compel Arbitration, and receiving legal advice from my attorney, I did not understand the effect the arbitration clause in my contract could have on my rights in the event there was a dispute between me and the Dealership." (*Id.*, at 0359 (Paragraph 9).)

Did the arbitration clause on the back of Mr. Sanchez's vehicle purchase contract fall within his reasonable expectations? Not a chance. The only evidence in the record is Mr. Sanchez's testimony he had no idea it was there and didn't know what it meant. Valencia Holding Company did not present any evidence he should have reasonably expected the arbitration clause on the back of his form contract to buy a car. Would a reasonable consumer agree to the terms of the arbitration clause used in this form contract? Not a chance. The arbitration clause is drafted to favor the dealership without any corresponding benefit to the consumer. Going back to the arbitration clause in *AT&T Mobility*, the United States Supreme Court did not address whether the consumers reasonably expected the arbitration clause. But it is possible a consumer would agree to an arbitration clause that said they didn't have to pay any money to resolve a dispute, prevented AT&T from ever recovering its attorney's fees, and included a minimum recovery of $7,500 if the consumer beat AT&T's last written settlement offer (regardless

of the amount in dispute). Clearly, AT&T had calculated the cost of consumer arbitrations, even with this minimum recovery, was a less expensive manner of doing business than facing the risk of class action lawsuits. And a reasonable consumer may have agreed to these terms to maximize their individual recovery. AT&T even threw in a carrot for consumer attorneys, promising them double their fees if they could beat AT&T's written settlement offer. Quite simply, AT&T drafted an arbitration clause that, if it fell within a consumer's reasonable expectations to have to arbitrate their disputes, a reasonable consumer might accept. Unfortunately for Valencia Holding Company, the arbitration clause in the form contract it used is not one a reasonable consumer would agree to.

In *A&M Produce Co. v. FMC Corp.* (1982) 135 Cal.App.4th 473, the court of appeal examined whether a disclaimer of warranties was unconscionable. The court cited the Indiana Supreme Court for the principal that "The burden should be on the party submitting [a standard contract] in printed form to show that the other party had knowledge of any unusual or unconscionable terms contained therein." (*Id.*, at 490 (citing *Weaver v. American Oil Company* (1972) 257 Ind. 458, 276 N.E.2d 144, 147-148).) Particularly appropriate in the arbitration context, the court also noted

> In fact, one suspects that the length, complexity and obtuseness of most form contracts may be due at least in part to the seller's preference that the buyer will be dissuaded from reading that to which he is supposedly agreeing. This process almost inevitably results in a one-sided "contract."

(*Id.*, at 490-491.)

Consumer adhesion contracts haven't changed for the better since *A&M Produce* was decided in 1982. Car dealers don't want consumers to know what they are supposedly agreeing to. The contract at issue in this case was used with millions of California consumers. The inclusion of an arbitration clause was not within their

reasonable expectations and consumers would not have agreed to the terms of this clause even if it was. Under the *Graham* test, the clause should not be enforced.

The reasonable consumer defense to terms in contracts of adhesion poses a problem, however, for traditional unconscionability analysis. The reasonable consumer standard looks at the contract of adhesion and how it can be enforced. It is a defense to all adhesion contracts. Under *A&M Produce*, the burden would be on the car dealer to show the arbitration clause included in the adhesion contract was not unusual or unconscionable. But California law puts the burden on a consumer opposing a motion to compel arbitration to prove their arbitration clause is unconscionable. (*Engalla v. Permanente Medical Group, Inc.* (1997) 15 Cal.4th 951, 972 ("The petitioner bears the burden of proving the existence of a valid arbitration agreement by the preponderance of the evidence, and a party opposing the petition bears the burden of proving by a preponderance of the evidence any fact necessary to its defense.").)

Should this Court revert to the test set forth in *Graham* for contracts of adhesion, the burdens will need to be clarified. It should remain the business's burden to prove the consumer reasonably expected the arbitration clause in the form contract. And it should remain the consumer's burden to show that if the clause was within the reasonable expectations of the consumer, that, given a choice, the consumer would not have agreed to the terms due to their unfairness.

IV. Conclusion

The goal in adhesion contracts should be fair terms. Adhesion contracts now govern almost every aspect of consumers' lives. Consumers lost the battle guaranteeing them access to the courts to resolve disputes. Businesses now want to know how much they can stack the dispute resolution system in their favor. How far is too far?

Arbitration clauses should be acceptable as fair to a reasonable consumer. If a consumer reasonably expects a business's adhesion contract to contain an arbitration

clause, then the arbitration clause should only be enforced if it contains terms a reasonable consumer would agree to if given the option to accept or reject the clause. To create any other standard will lead to the eventual extinction of consumer claims in court, as all businesses will insert arbitration clauses as favorable as possible into their adhesion contracts. Consumers already consider themselves David to corporate America's Goliath in consumer litigation. If Goliath gets to make the rules of the fight, David deserves a fighting chance. David gets that chance if this Court adopts the reasonable consumer standard proposed by Mr. Sanchez.

Sincerely yours,

Christopher P. Barry

cc: *See* Attached Proof of Service

PROOF OF SERVICE

Gil Sanchez v. Valencia Holding Company, LLC et al.
California Supreme Court Case No. S199119
Court of Appeal, State of California, Second Appellate District, Division One B228027
Los Angeles Superior Court Case No. BC433634

I am employed in the County of San Diego, State of California. I am over the age of 18 and not a party to the within action. My business address is: 10085 Carroll Canyon Road, Suite 100, San Diego, California 92131.

On **March 11, 2014**, I served the foregoing document(s) described as:

LETTER BRIEF DATED MARCH 11, 2014

on the interested parties in this action by mail at San Diego, California addressed as follows:

[X] **BY U.S. MAIL:** I enclosed the documents in a sealed envelope or package addressed to the persons at the addresses listed above and:

(1) [] deposited the sealed envelope with the United States Postal Service, with the postage fully prepaid.

(2) [X] placed the envelope for collection and mailing, following our ordinary business practices. I am readily familiar with the business's practice for collecting and processing correspondence for mailing. Under that practice, on the same day that correspondence is placed for collection and mailing, it is deposited in the ordinary course of business with the United States Postal Service, in a sealed envelope with postage thereon fully prepaid, at San Diego, California. I am aware that on motion of the party served, service is presumed invalid if postal cancellation date or postage meter date is more than one day after date of deposit for mailing in affidavit.

[X] **(STATE)** I declare under penalty of perjury under the laws of the State of California that the above is true and correct.

Executed on **March 11, 2014,** at San Diego, California.

Amie Ipatenco

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