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March 19, 2014

The Honorable Tani Cantil-Sakauye, Chief Justice
and Honorable Associate Justices
Supreme Court of California
350 McAllister Street
San Francisco, CA 94102-4797

Re: *Sanchez v. Valencia Holding Company, LLC*,
S199119

Dear Chief Justice Cantil-Sakauye and Associate Justices:

The Court has requested supplemental briefing on the proper standard for determining whether a contractual provision is substantively unconscionable under California law. In this supplemental reply, amici The Chamber of Commerce of the United States of America, the Association of Global Automakers, Inc., and the Alliance of Automobile Manufacturers wish to emphasize that whatever standard the Court adopts necessarily will apply to *all* contract terms, not only to arbitration agreements. That is because the Federal Arbitration Act preempts the application of legal doctrines such as unconscionability in a manner that disfavors arbitration provisions. (See, e.g., *AT&T Mobility LLC v. Concepcion* (2011) 131 S. Ct. 1740, 1747; *Perry v. Thomas* (1987) 482 U.S. 483, 492 n.9.) For that reason alone, this Court should reaffirm that the "shocks-the-conscience" standard—its traditional test for unconscionability—is the exclusive formulation to be used in California courts. In contrast to that standard, which has stood the test of time, the other formulations mentioned in this Court's order are of far more recent vintage, and have been applied almost entirely with respect to the enforceability of arbitration agreements.

This Court's continued adherence to the "shocks-the-conscience" standard would also be sound public policy. A more permissive formulation of the standard for substantive unconscionability would give judges a roving commission to strike down any contract that they deem unfair. That approach would undermine the stability and predictability of contracts, chilling economic activity. Those deleterious effects are unnecessary. The "shocks-the-conscience" test ensures that abusive contracts involving serious overreaching can be invalidated—both within and outside the arbitration context.

## I. This Court Should Reaffirm That The "Shocks-The-Conscience" Standard Is The Appropriate Test For Substantive Unconscionability In California.

### A. The "shocks-the-conscience" standard is the established test for substantive unconscionability.

From the beginning, unconscionability has been understood as a doctrine reserved for abusive contracts that are exceptionally unfair. As Justice Story explained long ago, the unconscionability doctrine applies only to those bargains that "no man in his senses and not under delusion would make on the one hand, and [that] no honest and fair man would accept on the other." (Joseph Story, Commentaries on Equity Jurisprudence (1853) § 244, p. 275; see also *Hume v. United States* (1889) 132 U.S. 406, 411 [quoting *Earl of Chesterfield v. Janssen* (1751) 28 Eng.Rep. 82] [same].) In keeping with that understanding of the limited nature of this contract defense, American courts have long held that contracts may be considered unconscionable only if they "shock the conscience." (*Osgood v. Franklin* (1816 N.Y.Ch.) 2 Johns.Ch. 1, 23 ["inequality" that justifies setting aside a contract "must be so strong and manifest as to shock the conscience and confound the judgment of any man of common sense"]; Story, *supra*, § 246, p. 277 ["unconscionableness" should be such conduct as would "shock the conscience"].)

Courts continue to adhere to this conception of unconscionability today. Not only does the "shocks-the-conscience" standard have deep roots in the American legal tradition, but only that standard has the advantage of being "derivative of the term 'unconscionable.'" (*California Grocers Association v. Bank of America* (1994) 22 Cal.App.4th 205, 215 (*Cal. Grocers*).) If any other standard were substituted for it, the term "unconscionability" would become a misnomer.

**B. California courts long applied the established test, developing other formulations of the test chiefly as a means of undermining arbitration provisions.**

For over a century, this Court—like the courts of many other States (see Valencia Supp. Br. 13-14 & fn.2)—has repeatedly adopted the traditional view of unconscionability as a doctrine concerned only with "such bargains as no man in his senses, and not under delusion, would make." (*Odell v. Moss* (1900) 130 Cal. 352, 358 [quoting Story, *supra*, § 244, p. 275]); *Herbert v. Lankershim* (1937) 9 Cal.2d 409, 484 [same]; *Swanson v. Hempstead* (1944) 64 Cal.App.2d 681, 688 ["the authorities are agreed" on this definition].) Over time, the "delusion" formulation has been largely supplanted by the phrase "shocks the conscience" in California decisions, including this Court's recent decision in *Pinnacle Museum Tower Association v. Pinnacle Market Development (US), LLC* (2012) 55 Cal.4th 223, 246 (*Pinnacle*). (See also Valencia Supp. Br. 15-17.) This shift is one of terminology rather than substance. The underlying meaning of the two phrases—which both derive from the same sources, including Justice Story's work—is the same: namely, that only the most egregious or "delusional" contracts can be invalidated as unconscionable.

But California courts—including this Court on occasion—have departed from this traditional approach by formulating new, more expansive versions of the substantive-unconscionability test, but almost always when analyzing arbitration agreements. (See

Broome, *An Unconscionable Application of the Unconscionability Doctrine: How the California Courts Are Circumventing the Federal Arbitration Act* (2006) 3 Hastings Bus. L.J. 39, 40.) Indeed, this Court first used *all* of the alternative formulations of the substantive-unconscionability test in cases involving challenges to arbitration agreements. (See *Sonic-Calabasas A, Inc. v. Moreno* (2013) 57 Cal.4th 1109, 1145 ["unreasonably favorable"] [term first used in vacated 2011 opinion]; *Little v. Auto Stiegler, Inc.* (2003) 29 Cal.4th 1064, 1071-1072 ["unfairly one-sided"] (*Little*); *Armendariz v. Foundation Health Psychcare Services, Inc.* (2000) 24 Cal.4th 83, 114 ["overly harsh"] (*Armendariz*); *Graham v. Scissor-Tail, Inc.* (1981) 28 Cal.3d 807, 820 ["unduly oppressive"].)

These open-ended and vague formulations improperly permit courts to strike down arbitration provisions based on invented requirements that do not apply to other contracts and thus violate the FAA. For example, some California courts have invalidated arbitration agreements for failure to satisfy a requirement of point-by-point "mutuality" that has no basis in ordinary contract law. (E.g., *Mercuro v. Superior Court* (2002) 96 Cal.App.4th 167, 176-177; see Chamber/Global/Alliance Br. 11-12.)

## II. The "Shocks-The-Conscience" Standard Will Avoid Throwing Contracts In California Into Disarray

### A. This Court should select a substantive-unconscionability standard that makes contract enforcement more predictable.

The alternative formulations of the substantive-unconscionability test do not sufficiently cabin judicial discretion and will drastically unsettle California contract law if broadly applied. It is critical that the Court select a standard that will result in predictable, uniform application.

Predictability is especially important here because unconscionability is an exception to the general principle that parties "will be bound by the contracts they

negotiate and enter" into, even if they are "ill-advised." (*Ginsberg v. Samson* (2012) 205 Cal.App.4th 873, 891.) The settled expectation that contracts will be enforced serves a vital economic purpose: "[t]he entire law of contracts, as well as the commercial value of contractual arrangements, would be substantially undermined if parties could back out of their contractual undertakings on th[e] basis" of a mere purported "bad bargain." (*Steinhardt v. Rudolph* (Fla.Dist.Ct.App. 1982) 422 So.2d 884, 890.) Indeed, "[t]he sanctity of valid contractual agreements … is of paramount importance and is rooted in both the United States and California Constitutions." (*Vernon v. Drexel Burnham & Co.* (1975) 52 Cal.App.3d 706, 716 (*Vernon*).) Courts should hesitate to destabilize the contract system by substituting their post-hoc judgment for that of the parties.

This is as true of standardized consumer contracts as it is of customized contracts between sophisticated parties. Today, businesses and consumers depend on standardized contracts to make their transactions predictable. An overly permissive approach to unconscionability could unsettle millions of contractual relationships and disrupt the business of the thousands of companies that rely on standardized contracts to operate. Thus, "there is perhaps no higher public policy than to uphold and give effect to contracts validly entered into and legally permissible in subject matter," whatever their form. (*Vernon*, *supra*, 52 Cal.App.3d at 716.)

The "shocks-the-conscience" test is the only standard that strikes an appropriate balance between the certainty of contracts and the goal of preventing gross unfairness between parties: "With a concept as nebulous as 'unconscionability' it is important that courts not be thrust in the paternalistic role of intervening to change contractual terms that the parties have agreed to merely because the court believes the terms are unreasonable" (*American Software, Inc. v. Ali* (1996) 46 Cal.App.4th 1386, 1391 (*Ali*));

the "shocks-the-conscience" standard is the best safeguard against disrupting contractual relationships that are at the foundation of modern commerce.

### B. Other formulations of the unconscionability test would enable arbitrary and unpredictable invalidation of contracts.

In contrast to the "shocks-the-conscience" standard, the alternative standards for unconscionability invite arbitrary outcomes; Sanchez himself recognizes (Supp. Br. 3) that these "subjective tests lead[] to inconsistent results." That is especially true of the "unreasonably favorable" standard endorsed by amicus Consumers for Auto Reliability and Safety (CARS).[1] Several panels of the Court of Appeal have explicitly rejected this approach (or one similar to it) because it imposes an "amorphous" standard that is "far too subjective to provide adequate guidance" to courts. (*Cal. Grocers*, *supra*, 22 Cal.App.4th at 214; see also (*Ali*, *supra*, 46 Cal.App.4th at 1391) [agreeing with *Cal. Grocers*].) As one court noted, "[t]he phrases 'harsh,' 'oppressive,' and 'shock the conscience' are not synonymous with 'unreasonable'"; an "unreasonably favorable" standard "inject[s] an inappropriate level of judicial subjectivity into the [unconscionability] analysis," because it allows the court to freely substitute its own

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[1] CARS' reference (Supp. Br. 1-2) to a well-known D.C. Circuit opinion (and several treatises quoting that opinion) support the "unreasonably favorable" standard (*Williams v. Walker-Thomas Furniture Co.* (D.C. Cir. 1965) 350 F.2d 445, 449) is misleading. The *Walker-Thomas* court acknowledged that Justice Story's "under delusion" formulation—the conceptual forerunner of the "shocks-the-conscience" test—is the "traditional test" for unconscionability. (*Id.* at 450 n.12 [quoting *Greer v. Tweed* (N.Y. Ct. C.P. 1872) 13 Abb. Pr. (N.S.) 427 [quoting in turn Story, *supra*, § 244]].) That court also pronounced the "correct" test to be "whether the [contract's] terms are *so extreme* as to appear unconscionable according to the mores and business practices of the time and place"—that is, whether the terms "shock the conscience" in light of contemporary business norms. (*Id.* at 450 [emphasis added; internal quotation marks omitted].)

conception of a reasonable contract for the one to which the parties actually agreed. (*Morris v. Redwood Empire Bancorp* (2005) 128 Cal.App.4th 1305, 1322.)

A test that focuses on whether a contract is "unfairly one-sided" similarly leaves far too much judicial discretion to discard aspects of contractual arrangements—in some cases radically altering the exchange between parties. As this Court made clear in *Pinnacle*, "[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*.'" (*Pinnacle*, *supra*, 55 Cal.4th at 246 [emphasis added; internal quotation marks omitted] [quoting *24 Hour Fitness, Inc. v. Superior Court* (1998) 66 Cal.App.4th 1199, 1213].) And tests that look to whether a contract or contractual term is "overly" harsh or "unduly" oppressive invite arbitrary and inconsistent application; the quantum of "harshness" or "oppressiveness" that makes a contract unconscionable under such tests is left to the eye of the beholder.

Sanchez argues (Supp. Br. 5-6) that the "shocks-the-conscience" standard is subjective too. But that standard is different from the other formulations that this Court has previously used. The traditional standard underscores that, in the mine run of cases, contracts ought not to be cast aside, whereas the alternative standards would afford courts virtually unbounded discretion to invalidate contract terms. Sanchez's depublished examples prove as much. The court below and the court in *Goodridge* applied the "unduly oppressive" test and struck down the arbitration provisions before them. (See *Sanchez v. Valencia Holding Co., LLC* (2011) 135 Cal.Rptr.3d 19, 32-33; *Goodridge v. KDF Automotive Group, Inc.* (2012) 147 Cal.Rptr.3d 16, 29.)[2] By contrast, the *Flores*

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[2] Sanchez suggests that the *Goodridge* court was applying the "shocks-the-conscience" standard, but that court specifically *denied* that it was applying that "higher" standard. (147 Cal.Rptr.3d at 29 n.4.)

court applied the "shocks-the-conscience" standard and upheld a similar provision. (*Flores v. W. Covina Auto Group* (2013) 151 Cal.Rptr.3d 481, 501-502.)

Similarly, amicus CARS cites cases purporting to show that the "shocks-the-conscience" standard is a subjective one and too difficult to satisfy—*all* of which are inapposite and come from an entirely different area of law: substantive due process. (See CARS Supp. Br. 4-6.) Tellingly, CARS offers not one example of a court opining that the standard is either too subjective or too demanding when applied to *contracts*. In fact, as we discuss below, there are numerous examples of courts invalidating contract provisions on this ground because, as respondent Valencia Holding Company points out, the "shocks-the-conscience" standard for unconscionability refers *not* to what shocks an individual judge's conscience, an approach that might entail subjectivity, but to what shocks the conscience of a person of "common sense" (Valencia Supp. Br. 24-25).

Sanchez also argues that the "shocks-the-conscience" standard is "no better" than the other formulations proffered by the Court because it is an "unattainable standard" and leads to "inconsistent results." (Sanchez Supp. Br. 6-7.) But the long line of decisions applying this standard, here and elsewhere, provides guidance that prevents the inconsistency that would result from this Court's adoption of a new standard that lacks such precedent. Indeed, Sanchez's only evidence that the "shocks-the-conscience" standard leads to inconsistency is his observation that practices that "shock the conscience" today—his strained example is "slavery"—might not have satisfied that standard long ago. (Sanchez Supp. Br. 6-7.)

Indeed, the "shocks-the-conscience" standard is far more objective and workable than the standard Sanchez himself proposes. Sanchez asks this Court to hold—without any basis in California law for doing so—that a contractual term is unenforceable unless

a "reasonable consumer" would accept the terms, given the opportunity. (*Id.* at 3.)[3] But that standard would allow courts to rewrite contracts at will, running roughshod over the principle that the doctrine of unconscionability should not permit parties to escape a bad bargain that they now regret. (*Ali*, *supra*, 46 Cal.App.4th at 1391; see also *Sonic-Calabasas A v. Moreno* (2013) 57 Cal.4th 1109, 1145 [recognizing that the unconscionability doctrine is not concerned with "'a simple old-fashioned bad bargain'"] [quoting *Schnuerle v. Insight Communications Co.* (Ky. 2012) 376 S.W.3d 561, 575].) Sanchez also cannot explain why his "reasonable consumer" standard is different from the sorts of "reasonableness" standards that several panels of the Court of Appeal have rejected (see p. 5, *supra*) and that *he himself opposes*. (See Sanchez Supp. Br. 6 ["When a test uses words like … "unreasonably," … politics come into play."].)

### C. The "shocks-the-conscience" standard permits invalidation of truly problematic contractual terms.

Though more stringent than the proposed alternative formulations of the substantive-unconscionability test, the "shocks-the-conscience" standard does permit courts to refuse to enforce grossly improper contract terms. The numerous courts that adhere to the "shocks-the-conscience" standard have no difficulty invalidating contractual provisions that do in fact shock the conscience. (See *Ryan v. Weiner* (Del. Ch. 1992) 610 A.2d 1377, 1380-1383, 1385 [invalidating vendor's conveyance of property in which he had substantial equity in exchange for nothing more than "a promise to be able to occupy the same house at a market-rate rent"]; see also, e.g., *Waters v. Min Ltd.* (Mass.

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[3] Sanchez's argument that a contractual term is also unconscionable if it is not "within the reasonable expectations of the consumer given the nature of the transaction" (Sanchez Supp. Br. 3) goes to whether the term was an unfair "surprise"—i.e., whether there is *procedural* unconscionability, not substantive unconscionability. (See, e.g., *Harper v. Ultimo* (2003) 113 Cal.App.4th 1402, 1406.)

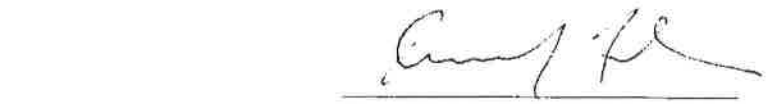
1992) 587 N.E.2d 231, 234 [sale, for $50,000, of annuity contract with immediate cash value of $189,000 by uncounseled 21-year-old was unconscionable].)

With respect to arbitration provisions, the "shocks-the-conscience" standard similarly permits invalidation of terms that are so grossly unfair as to be shocking. Courts have properly used this standard, for example, to invalidate provisions that imposed excessive costs on parties' access to the arbitral forum, provided for the selection of an arbitrator who was likely to be biased, or required that arbitration occur in a distant forum. (See, e.g., *Bolter v. Superior Court* (2001) 87 Cal.App.4th 900, 909-910 [arbitration provision requiring franchise owners in California to arbitrate in Salt Lake City was unconscionable]; *Sehulster Tunnels/Pre-Con v. Traylor Brothers, Inc./Obayashi Corp.* (2003) 111 Cal.App.4th 1328, 1342-1343 [ADR clause that gave subcontractor "no voice" in selection of members of review board was "biased" and unconscionable]; see also, e.g., *Hooters of America, Inc. v. Phillips* (4th Cir. 1999) 173 F.3d 933, 940 [arbitration agreement that set up a "sham system" with "biased rules" was unconscionable]; *Hill v. NHC Healthcare/Nashville, LLC* (Tenn.Ct.App. Aug. 25, 2008, No. M2005-01818-COA-R3-CV) 2008 WL 1901198, at *8, *16 [arbitration agreement unconscionable where cost to weaker party of initiating arbitration could reach $18,000]; *Philyaw v. Platinum Enterprises, Inc.* (2001) 54 Va.Cir. 364, at *3 [provision in service contract for vehicle purchased in Virginia, requiring arbitration in Los Angeles, was unconscionable].)

**Conclusion**

The Court should hold that *only* contracts whose terms "shock the conscience" are substantively unconscionable.

Sincerely,



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**CERTIFICATE OF WORD COUNT**
**(Cal. Rules of Court, rule 8.204)**

The text of this supplemental reply letter brief consists of 2,795 words, as counted by the Microsoft Word 2007 word-processing program used to generate the document.

Donald M. Falk

Dated: March 19, 2014

**CERTIFICATE OF SERVICE**
**S199119**

I, Kristine Neale, declare as follows:

I am a resident of the State of California and over the age of eighteen years, and not a party to the within action; my business address is: Two Palo Alto Square, Suite 300, 3000 El Camino Real, Palo Alto, California 94306-2112. On March 19, 2014, I served the foregoing document(s) described as:

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I am readily familiar with the firm's practice of collection and processing correspondence for mailing. Under that practice it would be deposited with the U.S. Postal Service on that same day with postage thereon fully prepaid in the ordinary course of business.

I declare under penalty of perjury that the foregoing is true and correct.

Executed on March 19, 2014, at Palo Alto, California.

Kristine Neale