The Arbitration Newsletter

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The Arbitration Newsletter is published periodically by Whitaker Chalk Swindle & Schwartz PLLC, Fort Worth, Texas, to explore the rapidly developing law and practice of commercial arbitration both in the U.S. and other countries.[1]

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TEXAS SUPREME COURT WARNS ABOUT MISUSE OF UNCONSCIONABILITY DEFENSE

VENTURE COTTON COOPERATIVE, et al. v. *FREEMAN, et al.* 2014 Tex. LEXIS 471, 2014 WL 2619535 (Tex. June 13, 2014)

The Texas Supreme Court has, again, "cautioned" Texas courts not to undermine the "liberal federal policy favoring arbitration agreements"[2] (in FAA cases) and not to "intrude upon arbitral jurisdiction under the guise of an unconscionability defense."[3] Questions[4] are often raised as "unconscionability" defenses in response to a motion to compel that "relate to the broader, container contract" and not to "the separable agreement to arbitrate."[5] These questions should be referred to the arbitrator and not addressed by a court under the unconscionability rubric.[6]

Shelby Alan Freeman and other cotton farmers in Gaines County (Seminole), Texas (the "farmers"), entered into contracts with a cotton cooperative-marketing association, Venture Cotton Cooperative ("Venture"), for the marketing and sale of the farmers' 2010 cotton crop. A dispute arose over how much of the 2010 crop had been committed to the co-op pool, when the price of cotton increased significantly during the 2010 growing season. The farmers sued Venture and its manager, Noble Americas Corporation, to rescind the contracts.[7] The contracts

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[1] Nothing in *The Arbitration Newsletter* is presented as or should be relied on as legal advice to clients or prospective clients. The sole purpose of *The Arbitration Newsletter* is to inform generally. The application of the comments in *The Arbitration Newsletter* to specific questions and cases should be discussed with the reader's independent legal counsel.

[2] *Venture Cotton*, 2014 WL 2619535, *8.

[3] *Id.; citing In re Olshan Foundation Repair Co., LLC*, 328 S.W.3d 883, 894 (Tex.2010).

[4] Such as "waiver, illegality, remedies, and attorney's fees." *Id.* at 8.

[5] 2014 WL 2619535, *8.

[6] *Id.*

[7] The farmers also requested a declaratory judgment, statutory attorney's fees, as well as claims for "fraud, negligent misrepresentation, breach of fiduciary duty, mutual mistake, civil conspiracy, and violations of the Texas Consumer Protection – Deceptive Trade Practices Act, and the Texas Free Enterprise and Antitrust Act of 1983. 2014 WL 2619535, *1.

all contained an arbitration clause governed by the Federal Arbitration Act ("FAA") that required use of the arbitration rules of the American Cotton Shippers Association ("ACSA") and gave attorney's fees to Venture upon breach of the contract by the farmers but not the same right to the farmers.[8] Venture asked the trial court in Gaines County to stay the litigation and compel arbitration. The farmers asked that the trial court deny these motions because the arbitration clause was unconscionable, which the trial court did. On interlocutory appeal, the Eastland Court of Appeals affirmed the trial court's denial of Venture motions to stay and compel arbitration because the arbitration clause prevented the farmers from exercising their statutory rights and remedies, and the attorney's fees in the ACSA arbitration rules "did not provide reciprocal rights to the farmers."[9]

The Texas Supreme Court reversed the Eastland Court of Appeals and remanded the case to that court for consideration of the other unconscionability arguments made by the farmers but not considered by the Court of Appeals.[10] But before remanding the case to the Court of Appeals, the Texas Supreme Court made a number of interesting observations about the unconscionability defense to arbitration agreements.

The FAA's "saving clause"[11] permits the application of "generally applicable [state law] contract defenses, such as fraud, duress, or unconscionability, but not [invalidation] by defenses that apply only to arbitration or that derive their meaning from the fact that an agreement to arbitrate is at issue."[12] This means the trial court hearing a motion to compel must construe the arbitration agreement as it would contracts "generally under state law."[13] The trial court cannot refuse to compel arbitration because the arbitration agreement is "unique" from other contracts.[14] An arbitration agreement cannot be found unconscionable unless "any contract" under the same circumstances would be found unconscionable under Texas law.[15]

If the arbitration agreement in question is not unconscionable, the farmers admit that their claims are arbitrable.[16] But "unconscionability" is "not easily defined."[17] In fact, it is difficult to define and requires a highly fact-intensive determination based on "a variety of factors," including a contract's "commercial setting, purpose and effect."[18] As early as a 1751 English decision, quoted later by at least two Texas courts, there is a description of a purported unconscionable contract.[19] The Texas Business and Commerce Code makes the unconscionability defense a question of law "that involves a highly fact-specific inquiry into the circumstances of the bargain, such as the commercial atmosphere in which the agreement was

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[8] 2014 WL 2619535, *2.
[9] 2014 WL 2619535, *2.
[10] 2014 WL 2619535, *9.
[11] 9 U.S.C. §2.
[12] 2014 WL 2619535, *3; *quoting AT&T Mobility LLC v. Concepcion*, 131 S.Ct. 1740, 1746 (2011); *AT&T Mobility quoting Doctor's Associates, Inc. v. Casarotto*, 517 U.S. 681, 687 (1996).
[13] 2014 WL 2619535, *3.
[14] *Id.*
[15] *Id.*
[16] *Id.*
[17] *Id.* at *4, citing two treatises.
[18] *Id.; citing TBCC §2.302(b)* and *RESTATEMENT (SECOND) OF CONTRACTS* §208, cmt. a.
[19] *Id., citing Earl of Chesterfield v. Janssen*, 28 Eng. Rep. 82, 100, 2 Ves. Sr. 125, 155 (1751).

made, the alternatives available to the parties at the time and their ability to bargain, any illegality or public-policy concerns, and the agreement's oppressive or shocking nature."[20]

The farmers urged the arbitration agreement in question was "one-sided and grossly unfair in **several respects**,"[21] and raised "**additional** [unconscionable] **concerns**" and had "**remaining arguments** attacking appellees' other substantive unconscionability and procedural unconscionability defenses" in the Court of Appeals not considered by that court in its decision to affirm the trial court on the two grounds of limitation of statutory remedies and non-reciprocal attorney's fees.[22]

The reliance on *In re Poly America, L.P.*[23] by the Court of Appeals missed the central teaching of *Poly America* – the public policy determination in *Poly America* did not require the invalidation of the arbitration agreement in question. It only required that the Workers' Compensation Act anti-retaliation waiver be severed from the arbitration agreement that remained otherwise enforceable.[24] The "essential purpose" of the Venture-farmers arbitration agreement "was to provide for a speedy and efficient resolution of disputes to ensure timely performance under the contract."[25] The attempted limitation of the farmers' statutory rights and remedies was not the "essential purpose" of the arbitration agreement in question.[26] Therefore, severance – not invalidation – was appropriate in *Venture*.[27]

Whether or not the arbitration process contracted for by Venture and the farmers would harm the farmers in the future was "speculative."[28] The "crucial inquiry" in determination of unconscionability established by *In re Olshan Foundation Repair Co., LLC*[29] asks "whether the arbitral forum in a particular case is an adequate and accessible substitute to litigation, a forum where the litigant can effectively vindicate his or her rights." But this "crucial inquiry" requires "specific proof in the particular case of the arbitral forum's inadequacy," not speculation.[30] These kinds of matters can easily migrate into "the broader, container contract."[31] When this happens, the court has invaded the province of the arbitrator and the question is no longer an arbitrability one.[32]

At this point the Texas Supreme Court issued its two warnings regarding the use of the unconscionability defense for more than a state law contract defense. At this point, the arbitrator should become involved and FAA preemption becomes a potential consideration.

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[20] *Id. at* *4, citing 49 *Texas Practice Series: Contract Law* §3.11.
[21] *Id. at* *3 and 4 (emphasis added).
[22] *Id. at* *8 (emphasis added).
[23] 262 S.W.3d 337 (Tex.2008).
[24] *Id.* at *4 and 5.
[25] *Id.* at *6.
[26] *Id.* at *6.
[27] *Id.* at *6 ("We accordingly conclude that the court of appeals erred in declining to sever the objectionable limitation on the farmers' statutory rights.").
[28] *Id.* at *7.
[29] 328 S.W.3d 883, 894 (Tex.2010).
[30] *Id.* at *7.
[31] *Id.*
[32] *Id.* at *8.

But, at the end of the day, the Eastland Court of Appeals now again has *Venture Cotton Cooperative v. Freeman* to examine all the farmers' unconscionability claims not yet addressed. Watch for further developments.

OBSERVATIONS

1. The unconscionability defense to the enforcement of an arbitration clause gives the trial judge a convenient way not to send parties to arbitration.

2. *Venture Cotton* involves sophisticated parties with extensive experience in all phases of cotton production and marketing. This is not a consumer contract.

3. The Texas Supreme Court, on the heels of its recent warnings in *Poly-America* and *Olshan Foundation*, have now gently reminded Texas trial courts not to lower the threshold of what it takes to make any contract, not just an arbitration contract, unconscionable.

4. The trial court does not have to invalidate the entire arbitration agreement; it can also sever out the offending part, and still send the parties to the arbitration they designed, as *Poly-America* teaches.

5. In *Venture Cotton* the parties have been up to the Texas Supreme Court and now find themselves still in an appellate court regarding the "highly fact-intensive" and ill-defined contract defense of unconscionability.

6. Be careful about your selection of arbitration rules when drafting your arbitration agreement, especially industry-specific arbitration rules that may not deliver a level playing field or that may be perceived by a trial judge as not creating a fair process for the parties.

7. If parties want the arbitrator to decide "arbitrability questions," the arbitration clause must clearly and expressly grant that power to the arbitrator.