

Employment Law

Commentary

Titans Clash and Uncertainty Abounds – The Ongoing Turmoil Regarding Enforceability of Mandatory Employment Arbitration Agreements in California

By Neil Perry

California has long been at odds with the liberal federal policy favoring arbitration that was established in the Federal Arbitration Act (FAA or Act). Congress enacted the FAA in 1925 to overcome “widespread judicial hostility” to arbitration and to prevent states from requiring a judicial forum for the resolution of claims that parties have agreed to resolve by arbitration.¹ Yet California courts continue to show a willingness to set aside private arbitration agreements in favor of preserving claimants’ access to judicial and administrative forums. Although the U.S. Supreme Court has found a number of these laws and decisions to be preempted by the FAA, recent decisions by California courts indicate that the uncertainty surrounding the enforceability of mandatory employment arbitration agreements in California is far from over.

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¹ *AT&T Mobility LLC v. Concepcion*, 131 S. Ct. 1740, 1745 (2011); *Buckeye Check Cashing, Inc. v. Cardegna*, 546 U.S. 440, 443 (2006).

The FAA's "Broad Principle of Enforceability"

The primary substance of the FAA is found in section 2 of the Act, which states that arbitration provisions in contracts "shall be valid, irrevocable, and enforceable, save upon such grounds as exist at law or in equity for the revocation of any contract."¹ Under this section, courts are required to place arbitration agreements on equal footing with other contracts and "rigorously" enforce them according to the terms agreed to by the parties.² The exception language at the end of the section, commonly referred to as the savings clause, allows for the invalidation of arbitration provisions by "generally applicable contract defenses, such as fraud, duress, or unconscionability."³ However, as the U.S. Supreme Court firmly established in two earlier cases involving California courts refusing to enforce arbitration agreements due to conflicts with state law, the FAA's broad principle of enforceability is not subject to any limitations under state law other than the general contract defenses.⁴

California's Unconscionability Doctrine

In more recent cases, California courts have sought to avoid FAA preemption by applying the state's broad unconscionability doctrine to invalidate private arbitration agreements. Under California law, unconscionability requires "a 'procedural' and a 'substantive' element, the former focusing on

'oppression' or 'surprise' due to unequal bargaining power, the latter on 'overly harsh' or 'one-sided' results."⁵ Mandatory pre-employment arbitration agreements are generally found to be procedurally unconscionable, as "few employees are in a position to refuse a job because of an arbitration agreement."⁶ Circumstances under which California courts have found arbitration agreements substantively unconscionable include provisions requiring the waiver of unwaivable rights or agreements exhibiting a lack of mutuality.

While unconscionability is a basis for invalidating an agreement under the FAA's savings clause, California's broad application of this doctrine and the U.S. Supreme Court's subsequent pushback has led to significant uncertainty as to what forms of employment arbitration agreements are enforceable in California. What follows is a discussion of three key areas where the enforceability of arbitration agreements remains in question.

Areas of Continuing Uncertainty

Waiver of Administrative Remedies

Whether an arbitration agreement may contain a waiver of statutory pre-litigation administrative procedures remains in dispute. In *Sonic Calabasas v. Moreno*, 51 Cal. 4th 659 (2011), a closely divided California Supreme Court refused to compel arbitration, holding that an arbitration provision requiring employees to waive their statutory right to request administrative resolution of wage-related disputes was unconscionable and contrary to public policy. Under the so-called "Berman" hearing process, an employee may file wage-related complaints with the Labor Commissioner and request a hearing.⁷ The commissioner may then conduct a hearing, prosecute a

civil suit against the employer, or take no action. In the event of a hearing, either party may request a *de novo* review in superior court, with the caveat that the unsuccessful party in the appeal must pay the other's attorneys' fees. Safeguards provided to employees in this process include: (1) the Commissioner is charged with enforcing her judgment; (2) an employer must post an undertaking in the amount of the order if appealing the Commissioner's decision; (3) the Commissioner may represent indigent employees and must represent employees attempting to uphold the Commissioner's award on appeal; and (4) for fee shifting purposes, an employee is only "unsuccessful" if he or she is awarded nothing in an appeal.⁸

Sonic asserted that the FAA required enforcement of the parties' arbitration agreement, which included a waiver of Moreno's right to request a Berman hearing. The California Supreme Court disagreed. The court reasoned that waiver of the Berman process violates public policy because the procedures further "the important and long-recognized public purpose of ensuring that works are paid wages owed" and requiring their waiver undermines and thwarts the public purpose behind the statutes.⁹ In terms of unconscionability, the court determined that the agreement, imposed as a condition of employment, was procedurally unconscionable in light of the "economic pressure exerted by employers on all but the most sought-after employees."¹⁰ It was also substantively unconscionable because the agreement required employees to forgo protections designed to level a playing field that generally favors employers with greater resources and bargaining power and thus was "markedly one sided."¹¹ The court

¹ 9 U.S.C. § 2.

² *Concepcion*, 131 S. Ct. at 1746; *Perry v. Thomas*, 482 U.S. 483, 490 (1987).

³ *Concepcion*, 131 S. Ct. at 1746.

⁴ In *Southland Corp v. Keating*, 465 U.S. 1 (1984), the U.S. Supreme Court concluded that California's Franchise Investment Law, which the California Supreme Court interpreted as requiring judicial consideration, conflicted with the FAA and violated the Supremacy Clause. Similarly, in *Perry*, *supra*, 482 U.S. at 491, the U.S. Supreme Court held that California Labor Code section 229, which a California appellate Court found was not subject to compulsory arbitration, violated the "clear federal policy" under the FAA to "rigorously enforce" private arbitration agreements and thus was preempted.

⁵ *Armendariz v. Foundation Health PsychCare Svcs.*, 24 Cal. 4th 83, 114 (2000).

⁶ *Id.* at 115.

⁷ See Cal. Labor Code § 98 *et al.*

⁸ See *Sonic*, 51 Cal 4th at 672-74.

⁹ *Id.* at 679.

¹⁰ *Id.* at 685-86 (citing *Armendariz*, 24 Cal. 4th at 115).

¹¹ *Id.* at 686.

further asserted that FAA preemption did not apply because arbitration would be—at most—delayed, as Sonic would be free to compel arbitration at the *de novo* appeal stage of the Berman process.

Sonic cited *Preston v. Ferrer*, 552 U.S. 346 (2008), for the principle that “when parties agree to arbitrate all questions arising under a contract, state laws lodging primary jurisdiction in another forum, whether judicial or administrative, are superseded by the FAA.”¹² In *Preston v. Ferrer*, 552 U.S. 346, 349-50 (2008), a California appellate court refused to compel arbitration involving a claim under California’s Talent Agencies Act (TAA) which vested “exclusive original jurisdiction” in the state’s Labor Commissioner. Similar to the Berman procedures, the TAA provides for a preliminary administrative hearing before the Labor Commissioner for a hearing and a *de novo* appeal before a superior court. The U.S. Supreme Court reversed, rejecting appellant’s argument that that arbitration could be merely postponed to take the place of the *de novo* review of the commissioner’s decision because postponing the arbitration would frustrate the “prime objective” of an arbitration agreement – to streamline proceedings and expedite results.

In spite of the similarities between the cases, the California Supreme Court found *Preston* distinguishable because the case involved a challenge of the parties’ entire contract, not just the arbitration provision and did not involve issues of unconscionability and public policy, and because the TAA procedures did not offer the same level of safeguards provided under the Berman procedures. The court remarked that it did not “understand the FAA to preempt a state’s authority to impose various preliminary proceedings that delay both the adjudication and the

arbitration of a cause of action in order to pursue important state interests” nor did it believe that *Preston* stood for “the proposition that this state’s public policy, which neither favors nor disfavors arbitration, must be invalidated because it may result in some delay in the commencement of arbitration.”

Three months after the release of *Sonic Calabasas*, the U.S. Supreme Court ruled in *AT&T Mobility, LLC v. Concepcion*, 131 S. Ct. 1740 (2011). In *Concepcion*, the Court addressed whether a mandatory arbitration agreement’s restriction on classwide arbitration was unconscionable under the FAA. The district court and the Ninth Circuit had both relied upon California Supreme Court precedent in *Discover Bank v. Superior Court*, 36 Cal. 4th 148 (2005), in ruling that the agreement’s disallowance of classwide arbitration was unconscionable because “AT&T had not shown that bilateral arbitration adequately substituted for the deterrent effects of class action.”¹³ Reiterating its focus on efficiency in *Preston*, the Court observed that requiring the availability of classwide arbitration would frustrate the prime objective of an arbitration agreement to achieve “streamlined proceedings and expeditious results.” Specifically, classwide arbitration would likely generate procedural morass and require formality. The Court also noted that the safeguards in the agreement, including a minimum payment and double attorneys’ fees if an arbitration award is issued that is larger than AT&T’s last settlement offer, were sufficient to provide incentive for individual claim prosecution. The U.S. Supreme Court thus reversed the lower court’s rulings, holding that the *Discover Bank* rule conflicted with the FAA and was preempted.

Concepcion addressed a number of the factors the California Supreme Court

used in *Sonic Calabasas* to differentiate *Preston*. For example, the dispute in *Concepcion* focused on the arbitration provision of the parties’ contract instead of the entire contract. In addition, the Court focused significantly on arbitration’s purpose of streamlining procedures and maximizing efficiency. Finally, the Court in *Concepcion* rejected the *Discover Bank* unconscionability analysis as a qualifying defense under the savings clause of the FAA’s section 2. Notably, in late-2011, the U.S. Supreme Court granted certiorari in *Sonic Calabasas*, vacated the California Supreme Court’s ruling and remanded for review in light of *Concepcion*.¹⁴ The California Supreme Court has subsequently asked the parties for supplemental briefing on the issue. It remains to be seen if the California Supreme Court will reverse its initial ruling in the matter or will further distinguish the case from *Concepcion*. Should the case make it to the U.S. Supreme Court, it is also unclear whether the unconscionability analysis in *Sonic Calabasas* will survive preemption by the FAA.

Waiver of Representative PAGA Actions and Other Public Wrong Remedies

Another issue still to be decided by the state and federal high courts is whether arbitration agreements may require waiver of representative actions involving the remedy of “public wrongs.” In *Brown v. Ralphs Grocery*, 197 Cal. App. 4th 489 (2011), a California appellate court addressed whether an arbitration agreement may require waiver of representative Private Attorney General Act (PAGA) actions. PAGA was established to help remedy understaffing of the state’s labor enforcement agencies. It allows an aggrieved employee to collect penalties from his or her employer for Labor Code violations, with 75% of the penalties going to the state and 25%

¹² *Id.* at 349-50.

¹³ *Id.* at 1745.

¹⁴ *Sonic Calabasas A, Inc. v. Moreno*, 132 S. Ct. 496 (2011).

going to the employee. PAGA actions can be representative actions, but do not require class action-type formalities in their prosecution.

In its ruling, the California Court of Appeal acknowledged *Concepcion*, but went to great efforts to differentiate that decision from the present case. First, it asserted that PAGA suits are more like state enforcement actions than private lawsuits and focus on enforcing the Labor Code rather than obtaining restitution. The court equated PAGA actions with others involving the remedy of “public wrongs,” such as actions under California’s Unfair Competition Law and Consumer Legal Remedies Act, for which there is California case law declining to compel arbitration. Second, the court noted that, unlike in *Concepcion*, PAGA representative actions do not involve long drawn out class procedural requirements that would significantly impact the efficiencies of the arbitration process. Finally, the court asserted, similar to the California Supreme Court’s opinion in *Sonic Calabasas*, that preemption by the FAA would nullify in large part the benefits of private attorney general actions. The court concluded that, because the U.S. Supreme Court has not directly addressed FAA preemption of a statute like PAGA, it would follow what it believes to be California law.

Brown is one of a number of cases in which courts have considered whether arbitration agreements may include PAGA waivers in light of *Concepcion*. Certain district courts have followed the logic of the *Brown* court, finding unconscionability and no preemption.¹⁵ Others have concluded that, under *Concepcion*, the FAA preempts state law regarding PAGA representative actions.¹⁶ It appears inevitable that

¹⁵ See, e.g., *Urbino v. Orkin Services of Cal., Inc.*, 2011 U.S. Dist. LEXIS 114746 (C.D. Cal., Oct. 5, 2011) (following *Brown*).

¹⁶ See, e.g., *Quevedo v. Macy’s, Inc.*, 2011 U.S. Dist. LEXIS 83046 (C.D. Cal., June 16, 2011) (“requiring arbitration agreements to allow for representative PAGA claims on behalf of other employees would be inconsistent with the FAA”).

this question (or the larger question of whether the FAA preempts statutes designed to prosecute public wrongs) will be addressed by federal appellate courts in the future.

Further Application of California’s Unconscionability Doctrine

Two other California decisions released in 2011 indicate that employers need to be careful in drafting their arbitration provisions to avoid invalidation under the state’s unconscionability doctrine.

In *Wisdom v. AccentCare, Inc.*, 2012 Cal. App. LEXIS 1 (Jan. 3, 2012), a California appellate court found a pre-employment mandatory arbitration agreement to be both procedurally and substantively unconscionable. The court cited the following factors as indications of procedural unconscionability: (1) the employees had no opportunity to negotiate; (2) the American Arbitration Association (AAA) rules cited in the agreement were not spelled out or provided to the employees; and (3) the employees did not understand that they were waiving their rights. The court found the agreement substantially unconscionable because the language only called for claims made by employees to be arbitrated. Even though the employer argued that it was implied that the arbitration provision was mutually binding, the court cited other agreements drafted by the employer that showed it “knew how to draft a bilateral agreement.”¹⁷

Similarly, the court in *Zullo v. Superior Court*, 197 Cal. App. 4th 477 (2011), found the arbitration provision at issue to be unconscionable. Factors identified by the court as indicators of procedural unconscionability included: (1) the agreement was a contract of adhesion; (2) the provision was located within an employee handbook (even though the handbook acknowledgement form specifically called attention to the arbitration

¹⁷ *Id.* at *17.

provision and its scope); and (3) the AAA rules cited were not provided. Even though the agreement was bilateral and binding on both the employer and employee, the court found the agreement substantively unconscionable due to the agreement’s inclusion of claims typically filed by the employee and exclusion of claims typically filed by the employer which indicated a lack of mutuality and made the agreement “harsh and one sided.”¹⁸

It is unclear whether the U.S. Supreme Court will narrow the scope of California’s unconscionability doctrine with regard to arbitration agreements in the future. In the meantime, these cases strongly indicate employers must keep a close eye on arbitration-related case law to ensure that their arbitration agreements are in compliance with current law regarding unconscionability.

Conclusion

The uncertainty regarding the enforcement of mandatory arbitration agreements in California will likely continue for the foreseeable future. Although the U.S. Supreme Court has made it clear that the FAA will be construed broadly, California courts have shown an adeptness at differentiating cases from U.S. Supreme Court precedent. As such, it is likely that the Court will need to continue addressing categories of California-specific cases (e.g., public wrong statutes, administrative remedies, scope of unconscionability, etc.) in order to more clearly define the parameters of the FAA’s scope. Until then, employers must regularly review their arbitration agreements and keep a close eye on key developments in this area.

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¹⁸ *Id.* at 486.

D.R. Horton, Inc. – The NLRB Weighs in on Class Waivers

In *D.R. Horton, Inc.*, a ruling released by the National Labor Relations Board (NLRB or Board) earlier this month, the Board analyzed whether it is a violation of the National Labor Relations Act (NLRA) for an employer to require its employees to sign an arbitration agreement that waives the employees' right to pursue employment-related class or collective claims in any forum, arbitral or judicial.

Charging Party Michael Cuda was employed by D.R. Horton as a non-union superintendent. As a condition of his continued employment, Cuda was required to execute a "Mutual Arbitration Agreement" (MAA) requiring that all employment-related claims be resolved through individual arbitration. Cuda filed an unfair labor practice charge, and the General Counsel issued a complaint, alleging that D.R. Horton violated: (1) Section 8(a)(4) and (1) of the NLRA by requiring all employment-related disputes to be submitted to arbitration and thus interfering with employee access to the NLRB; and (2) Section 8(a)(1) of the NLRA by maintaining the MAA provision precluding class or collective actions or the award of relief to a group or class of employees.

The NLRB affirmed the administrative law judge's unexceptional ruling that D.R. Horton violated Section (8)

(a)(4) and (1) because the language of the MAA "would lead employees reasonably to believe that they were prohibited from filing unfair labor practice charges with the Board." This portion of the decision follows clear precedent that employers may not require arbitration of unfair labor practices.

However, in a far more controversial move, the Board reversed the judge's dismissal of the allegation that the class-action waiver violated Section 8(a)(1), deciding instead that class actions qualify as "collective concerted activity" under Section 7 of the NLRA and because employees cannot be required to waive Section 7 rights as a condition of employment, the MAA's class-action waiver violated Section 7. Should courts adopt the Board's position, class-action waivers that are executed as a condition of employment – whether in arbitration agreements or otherwise – would be unenforceable, notwithstanding the U.S. Supreme Court's ruling in *AT&T Mobility LLC v. Concepcion*.

The enforceability of class-action waivers is far from settled. It is virtually assured that the *D.R. Horton* ruling will be appealed. In addition, other courts will need to weigh in on the scope and content of the Board's decision.

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