

Undermining Arbitration

by D. Gregory Valenza

The California Supreme Court's Aug. 30 decision in *Gentry v. Superior Court* tightens the courts' reins on "pre-dispute" agreements to arbitrate employment law claims. A pre-dispute arbitration agreement, by definition, is one to which the parties agree before any dispute between them has arisen.

The high court in *Gentry* decided two important issues. First, even if there is an otherwise enforceable agreement to arbitrate, employees generally cannot waive the right to bring a class action in arbitration. Second, even if the employer offers employees the opportunity to opt out of a pre-dispute arbitration agreement, the employee may challenge the agreement as unconscionable or void against public policy. The *Gentry* decision is another in a series of court rulings rendering pre-dispute agreements to arbitrate employment conflicts nearly pointless in California.

Disfavoring Agreements

By way of background, courts have expressed disfavor toward arbitration agreements since their invention. Courts perceive arbitration as an ouster of their jurisdiction via private agreement. At the beginning of the 20th century, Congress passed the Federal Arbitration Act (FAA), which was intended to protect arbitration agreements from heightened judicial scrutiny. The Supreme Court has held that the FAA pre-empts state laws that expressly impose special requirements on arbitration agreements.

Based on the FAA's text, courts for years wrangled over whether the act applied to employment arbitration at all. In 2001,

the U.S. Supreme Court settled that issue in *Circuit City v. Adams*, 532 U.S. 105. The court held that the law applies to all employees, except those directly involved in interstate transportation jobs. The debate over whether federal discrimination claims may be subjected to mandatory arbitration, a separate issue, was settled when the 9th U.S. Circuit Court of Appeals decided *EEOC v. Luce, Forward et al.*, 345 F.3d 742 (9th Cir. 2003) (en banc).

Where the FAA applies, arbitration agreements between employers and their employees generally must be enforced. But Section 2 of the FAA expressly provides that a court may refuse to enforce an arbitration agreement on grounds that would be applicable to any contract. That exception is how courts continue to invalidate arbitration agreements.

California law provides two bases for continued scrutiny of arbitration agreements under Section 2. First, courts need not enforce contracts, including arbitration agreements, that include "exculpatory clauses" or waivers of rights guaranteed by statute. Contracts containing such waivers are void as against public policy. Second, "unconscionable" contracts, including arbitration agreements, are unenforceable.

The California Supreme Court in *Armendariz v. Foundation Health Psychcare Serv.*, 24 Cal.4th 83 (2000), recognized that agreements to arbitrate employment claims generally are enforceable under the FAA. However, the court decided that pre-dispute, mandatory arbitration agreements must be drafted so they do not restrict employees'

pursuit of "unwaivable" rights guaranteed by statute, such as discrimination claims under the Fair Employment and Housing Act.

The court announced a multi-factor test, including requirements that the employer pay all costs peculiar to arbitration; that a neutral arbitrator is selected; that arbitration agreements be "mutual"; that adequate discovery be permitted, and more. Later decisions extended *Armendariz's* requirements to common law claims for wrongful termination in violation of public policy, and statutory wage and hour claims. So far, courts have held that the *Armendariz* requirements do not violate the FAA.

Measuring Unconscionability

The court in *Armendariz* also analyzed the unconscionability defense. To be invalid, an agreement must be both "procedurally" and "substantively" unconscionable. Both factors must be present, but not in equal measure. Courts apply a "sliding scale": the more an agreement is procedurally unconscionable, the less substantive unconscionability is necessary, and vice versa. Procedural unconscionability typically refers to the degree of oppression, surprise, or unequal bargaining power. If the agreement is a contract of adhesion, presented as "take it or leave it," courts typically find procedural unconscionability.

Substantive unconscionability focuses on whether the terms of the agreement are overly harsh or too one-sided. Decisions following *Armendariz* have invalidated as unconscionable provisions carving out claims that the employer may assert in

court rather than arbitration, narrowing the statute of limitations, limiting available remedies, prescribing arbitration venues that were inconvenient to the employee, and a host of others.

The 'Gentry' Case

The Supreme Court in *Gentry* addressed both the “unwaivable rights” and unconscionability issues. Robert Gentry brought a class action against his employer, Circuit City, for unpaid overtime. He claimed he and the other customer service managers in the putative class were wrongly classified as “exempt” from overtime laws. When hired, Gentry signed an arbitration agreement. However, the agreement precluded the arbitrator from joining other associates’ claims, essentially precluding class actions in arbitration. Gentry challenged this provision.

While Gentry’s appeal was pending, the Supreme Court held in *Discover Bank v. Superior Court*, 36 Cal.4th 148 (2005), that a class action waiver contained in a credit card company’s cardmember agreement was unconscionable. The court’s rationale seemed to be based on the small amounts of damages involved, as well as the fact that the class-action waiver and arbitration agreement were part of a “bill stuffer” amending the card member agreement.

Gentry’s case was different. Gentry had 30 days to opt out of his arbitration agreement, which was expressly given to him, not stuffed in an envelope. And overtime claims are worth far more than the \$29 late fee at issue in *Discover Bank*. Reviewing Gentry’s case, the Court of Appeal enforced the class action waiver against Gentry, leaving him to arbitrate his own claim. The Supreme Court reversed the Court of Appeal. In a 4-3 decision, the court decided that class action waivers in employment arbitration agreements “may” be void because they impermissibly impede employees’ unwaivable statutory rights. Before enforcing such a waiver, a court must consider “the modest size of the potential individual recovery, the potential for retaliation against members

of the class, the fact that absent members of the class may be ill informed about their rights, and other real world obstacles to the vindication of class members’ right to overtime pay through individual arbitration.” Put another way, to employers seeking to enforce class action waivers, whether in arbitration or otherwise: Good luck.

The court rejected Circuit City’s arguments (and the dissent’s position) that Gentry himself was free to pursue his own overtime pay claim. The court essentially elevated the ability to bring a class action to be an integral part of an individual’s right to claim unpaid overtime. The court also rejected Circuit City’s FAA pre-emption argument. The court held that class-action waivers not contained in arbitration agreements would be void under the same analysis. The Supreme Court severed the class-action waiver from the arbitration agreement. But Gentry also attacked the remainder of the arbitration agreement as unconscionable, based on other provisions contained therein. For example, the agreement contained a reduced statute of limitations and a limit on punitive damages.

Circuit City argued to the Supreme Court that because it gave employees 30 days to “opt-out” of the agreement, it could not be procedurally unconscionable. And without procedural unconscionability, Circuit City pointed out, the agreement was immune to attack on unconscionability grounds. The Court of Appeal agreed with this position and did not reach the issue of substantive unconscionability.

The Supreme Court agreed that without procedural unconscionability, the courts cannot invalidate a contract as substantively unconscionable. But then the court’s majority decided that the agreement was at least a little procedurally unconscionable, regardless of the 30 day opt-out period. In doing so, the court summarily rejected two 9th Circuit decisions holding that a similar Circuit City agreement was valid because of the opt-out.

To find procedural unconscionability, the Supreme Court noted that Circuit City did not fairly explain the disadvantages of its arbitration agreement. The court also decided that at least some employees could be too fearful of retaliation to reject the arbitration agreement. The majority dismissed the express provision advising employees to review the agreement with counsel or to ask questions, believing it was unrealistic that any employee other than a “higher echelon” manager would do so. Therefore, the Supreme Court remanded the case so that lower courts could consider whether the agreement was substantively unconscionable and unenforceable.

Worth the Candle?

Justice Marvin Baxter in his dissenting opinion (in which Justices Ming Chin and Carol Corrigan joined) observed that the California Supreme Court’s arbitration jurisprudence has rendered pre-dispute arbitration agreements nearly pointless. The courts now require arbitration of the most common employment law claims to be conducted on the same terms as court litigation, with the main difference being the absence of a courthouse and jury.

Arbitration was once considered a fast, cheap alternative to litigation. When one considers the arbitrator’s and administrative fees of arbitration, on top of the numerous obligations *Armendariz* and its progeny impose, the arbitration of employment claims may well cost employers as much as court litigation. Employers seeking to impose mandatory, pre-dispute arbitration agreements therefore may wish to consider whether they are worth the candle. On the other hand, as the majority in *Gentry* emphasized, employers and employees freely may enter into post-dispute agreements to arbitrate, which are not scrutinized to the same extent as the pre-dispute variety.

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