

## **Arbitration Update: The Federal Arbitration Act Rules By William E. Weinberger**

### **I. Introduction – The Supreme Court’s Insistence on Enforcement of Arbitration Agreements Pushes California Courts to Reexamine Judicially Created Doctrines That Had Limited Enforceability.**

Six California appellate court decisions since the last issue of the Parker Milliken *Labor Law Update* on April 24, 2012 show, *first*, that recent U.S. Supreme Court decisions upholding arbitration agreements containing class-action waivers have pushed the California courts to rethink their prior apparent hostility to such agreements, and, *second*, that courts still will not hesitate to find inartfully drafted arbitration provisions unenforceable where they fail to contain bilateral arbitration provisions in a document that clearly gives the employee notice of the arbitration provision and class-action waiver.

Therefore, now is the opportune time to make sure your arbitration documents are up-to-date. We assist many clients in developing their arbitration policies.

The recent California cases instruct employers as follows:

1. More California courts are enforcing a class-action waiver in a well-defined arbitration agreement without engaging in the determination under *Gentry v. Superior Court* (2007) 42 Cal. 4th 443, as to whether a class action would be a more effective way to vindicate statutory rights for employees.
2. Even where a court finds that *Gentry* is binding until the California Supreme Court gives guidance on how recent U.S. Supreme Court jurisprudence has impacted it, the court will require the plaintiff to make a particular, specific showing of the *Gentry* factors. Where such factors are shown, the courts will not impose class arbitration on an employer who did not consent to it, but may, then, find the arbitration agreement unenforceable.
3. Although a California appellate court held late last year that a class-action waiver in an arbitration agreement is unenforceable in reference to representative claims under California’s Private Attorney General Act, more courts now enforce class-action waivers even in the context of PAGA claims. PAGA is a California statute that authorizes an individual employee to bring an action on behalf of himself and other employees to remedy certain alleged wage and hour violations.
4. The California courts that are upholding a class-action waiver in an arbitration agreement also find that they are not bound by the recent National Labor Relations Board decision determining a class-action waiver a violation of section 7 of the National Labor Relations Act.

5. It is still of utmost importance for employers to draft a well-defined arbitration agreement giving employees notice of the provisions and the arbitration procedures that will be followed. Otherwise, the arbitration provision is at risk of being held unenforceable.

6. If an employer decides that the best way to establish an arbitration procedure for employment claims is through a policy in an employee handbook rather than an arbitration agreement, the employer should take measures to have the employee acknowledge receipt not just of the handbook but also specifically of the arbitration provisions.

## II. The California Appellate Cases Bending Toward the Supreme Court's Strong Support for Arbitration Agreements

Five recent California appellate court decisions show the powerful impact the recent U.S. Supreme Court decisions enforcing Federal Arbitration Act (9 U.S.C. § 1 et seq.) ("FAA") preemption continue to have on state case and statutory law that had invalidated arbitration agreements containing class-action waivers. In the recent California decisions, the courts have tended to enforce class-action waivers and find inapplicable or unenforceable California cases and statutes precluding class-action waivers.

In *Kinecta Alternative Financial Solutions, Inc. v. Superior Court* (2012) 205 Cal.App.4th 506, the Court of Appeal (2nd District) held that *Gentry v. Superior Court* (2007) 42 Cal. 4th 443 is still binding, because it was not "expressly abrogated or overruled" by *AT&T Mobility v. Concepcion* (2011) 563 U.S. \_\_\_, 131 S.Ct. 1740. *Gentry* established a four-factor test to determine whether a class-action waiver in an arbitration agreement is invalid in a case in which a plaintiff is seeking damages for violations of wage and hour laws.<sup>1</sup> Nevertheless, because the arbitration agreement at issue in *Kinecta* "made no reference to, and did not authorize, class arbitration of disputes," the trial court's order denying the defendant's motion to dismiss class claims had to be reversed under the holding in *Stolt-Nielsen v. Animalfeeds International Corp.* (2010) 559 U.S. \_\_\_, 130 S.Ct. 1758. *Stolt-Nielsen* held "that under the FAA, a party may not be compelled to submit to class arbitration unless the arbitration contract provides a basis for concluding that the party agreed to do so." (*Kinecta*, at p. 510.)

After plaintiff Kim Malone filed a complaint for individual and class claims under California's wage and hour laws, Kinecta filed a motion to compel arbitration and to dismiss the class claims. Kinecta based the motion on a written arbitration agreement, which contained, among other terms, the provision, "I further agree and acknowledge that [Kinecta] and I will utilize binding arbitration to resolve all disputes that may arise out of the employment context." The trial court granted the motion to compel arbitration but denied the motion to dismiss class claims, and thereby "imposed class arbitration, even though the arbitration provision was silent on the issue of class arbitration and limited the arbitration to disputes between Malone and Kinecta." (*Id.* at 509.)

<sup>1</sup> The purpose of the four-part *Gentry* test is to make a judicial determination whether "class arbitration is likely to be a significantly more effective practical means of vindicating the employees' rights than individual litigation or arbitration, and" whether "disallowance of the class action would likely lead to a less comprehensive enforcement of overtime laws for employees affected by the employer's violations . . ." (*Kinecta*, at 510 (citing *Gentry*, 42 Cal. 4th at 463).)

The *Kinecta* Court explained that *Stolt-Nielsen*'s holding was based upon the voluntary contractual basis of arbitration:

“Under the FAA, a valid arbitration agreement arises from the parties’ consent, not coercion, and the primary purpose of the FAA is to ensure that agreements to arbitrate are enforced according to their terms. . . . Thus arbitration, as a matter of contract between the parties, is a way to resolve only those disputes which the parties have agreed to submit to arbitration.” (*Id.* at 518 (citing *Stolt-Nielsen*, 130 S.Ct. at 1774).)

The trial court had erred in denying Kinecta’s motion to dismiss class claims because, in doing so, “the order compelling arbitration imposed class arbitration even though the arbitration provision was limited to the arbitration of disputes between Malone and Kinecta.” (*Id.* at 518.)

Although the *Kinecta* Court found that *Gentry* was still binding, it also found that the plaintiff had not offered any evidence to show the four *Gentry* factors to establish that the arbitration agreement with Kinecta was invalid. The plaintiff’s evidence had been much too general and generic. (*Id.* at 517.)

Unlike the *Kinecta* Court, the Court in *Iskanian v. CLS Transportation Los Angeles* (2012) 206 Cal.App. 4th 949, held “that the *Concepcion* decision conclusively invalidates the *Gentry* test.” The *Iskanian* Court explained that it was compelled to hold the *Gentry* test inapplicable, because the determination was a matter of federal law. “Because this matter involves analysis of the effect of a federal law, the FAA, on a state rule, we must follow the United States Supreme Court’s lead.” (*Id.* at 960.)

The Court’s holding that the *Gentry* test could not be applied was based on three reasons: First, the result of a plaintiff sustaining his burden to show the four *Gentry* factors was that the defendant would be required to engage in class arbitration, despite its lack of consent to do so. “*Concepcion* thoroughly rejected the concept that class arbitration procedures could be imposed on a party who never agreed to them. . . . This unequivocal rejection of court-imposed class arbitration applies just as squarely to the *Gentry* test as it did to the *Discover Bank* rule [which the Court explicitly overruled].” (*Id.* at 959 (citing *Concepcion*, 131 S.Ct. at 1750-51).)

Second, even if, as the plaintiff argued, “the *Gentry* rule rested primarily on a public policy rationale, and not on *Discover Bank*’s unconscionability rationale . . . , [a] rule like the one in *Gentry* – requiring courts to determine whether to impose class arbitration on parties who contractually rejected it – cannot be considered consistent with the objective of enforcing arbitration agreements according to their terms.” (*Id.* at 960.)

Third, the benefit of class arbitration is not a factor that courts may consider in determining whether to enforce a class action waiver in an arbitration agreement. That the plaintiff was seeking in his class action “to ‘vindicate statutory rights’ is irrelevant in the wake of *Concepcion*. As the *Concepcion* court reiterated, ‘States cannot require a procedure that is inconsistent with the FAA, even if it is desirable for unrelated reasons.’ (131 S.Ct. at 1753.)” (*Id.* at 960.)

The *Iskanian* Court refused to follow the post-*Concepcion* decision by the National Labor Relations Board in *D.R. Horton* (2012) 357 NLRB No. 184, 2012 WL 36274 at p.\*2, that “a mandatory employer-imposed agreement requiring all employment-related disputes to be resolved through individual arbitration . . . violated the National Labor Relations Act (NLRA) because it prohibited the exercise of substantive rights protected by section 7 of the NLRA.”<sup>2</sup> Had the NLRB restricted its decision to an interpretation of the NLRA, the Court would have been bound to follow it. “The *D.R. Horton* decision, however, went well beyond an analysis of the relevant sections of the NLRA. Crucially, the decision interpreted the FAA . . . . As the FAA is not a statute the NLRB is charged with interpreting, we are under no obligation to defer to the NLRB’s analysis.” By contrast, the *Concepcion* decision, which was binding, “made no exception for employment-related disputes” in adhering to “the general rule that arbitration agreements be enforced according to their terms . . . .” (*Id.* at 962.)

Finally, *Iskanian* disagreed with another division of the Second District Court of Appeal, which had “held the *Concepcion* holding does not apply to representative actions under the [Private Attorney General Act (Labor Code § 2699(a)) (“PAGA”)], and therefore a waiver of PAGA representative actions is unenforceable under California law.” (*Id.* at 964 (citing *Brown v. Ralphs Grocery Co.* (2011) 197 Cal.App.4th 489, 494).) Although the Court “recognize[d] that the PAGA serves to benefit the public and that private attorney general laws may be severely undercut by application of the FAA,” the Court was compelled to follow the Supreme Court’s authority. “Under *Southland Corp. v. Keating* [(1984)] 465 U.S. 1, and *Concepcion, supra*, 131 S. Ct. 1740, any state rule prohibiting the arbitration of a PAGA claim is displaced by the FAA.” (*Id.* at 964.)

In a more recent case from the Fourth District Court of Appeal the Court reviewed the development of case law from the California Supreme Court and United States Supreme Court on enforcement of arbitration agreements since 2000. The ultimate case, *Concepcion*, the Court noted, rejected “the argument that a state may require a procedure inconsistent with the FAA because the state seeks to ensure that parties with ‘small-dollar claims’ have redress in the legal system,” and “concluded that ‘class arbitration, to the extent it is manufactured by [the] *Discover Bank* [rule] rather than consensual, is inconsistent with [and preempted by] the FAA.’” (*Id.* at pp. 1753, 1751.)” (*Truly Nolen v. Superior Court* (Aug. 13, 2012) \_\_\_ Cal.App.4th \_\_\_, 2012 WL 3222211.) Although after *Concepcion*, “most federal courts and at least one state court [*Iskanian*] have concluded that *Concepcion*’s broad language and reasoning undermines *Gentry*’s rationale,” the *Truly Nolen* Court concluded that it could not disregard *Gentry* “without specific guidance from” the California Supreme Court because “the United States Supreme Court did not directly address the precise issue presented in *Gentry*.” (*Id.* at \*13.)

Before it came to this conclusion, however, the Court strongly suggested that *Concepcion*’s reasoning applies to *Gentry* as much as it applied to *Discover Bank*.

“*Concepcion*’s holding was unrelated to the fact that *Discover Bank* was a particular application of California’s unconscionability

<sup>2</sup> Section 7 of the NLRA provides that employees have the right “to engage in . . . concerted activities for the purpose of collective bargaining or other mutual aid or protection . . . .” (29 U.S.C. § 157.)

analysis. *Concepcion* reaffirmed the validity of a state's general unconscionability defense as applied to arbitration agreements, but found *Discover Bank* objectionable mainly because it allowed courts to ignore and refuse to enforce the clear terms of the parties' agreement, and instead employ a judicial policy judgment that the class procedure would better promote the vindication of the parties' rights in certain cases. This discredited reasoning is the same rationale employed by the *Gentry* court." (*Id.* at \*13.)

The Court noted, "Under the reasoning of *Concepcion* and *Stolt-Nielsen*, absent a showing of mutual consent, it is questionable whether courts can validly invoke *Gentry* to require an objecting party to engage in classwide arbitration." (*Id.* at \*13.)

Applying the *Gentry* test, the Court found that the plaintiff had failed to sustain its burden to show that the four factors invalidated the arbitration agreement and class-action waiver. (*Id.* at \*14 -- \*18.)

And as in *Iskanian*, the *Truly Nolen* Court refused to follow the NLRB's *D.R. Horton* decision, because "the United States Supreme Court has held that arbitration agreements pertaining to statutory claims must be enforced according to their terms, absent an express 'contrary congressional command' overriding the FAA." (*CompuCredit v. Greenwood* (2012) 565 U.S. \_\_\_, 132 S.Ct. at p.670.)" (*Id.* at \*21.)

In the most recent case, *Reyes v. Liberman Broadcasting, Inc.* (2d Dist. Aug. 31, 2012) \_\_ Cal.App.4th \_\_, 2012 WL 3775879, the Court followed the trend of the cases cited above. (1) It held that where an arbitration agreement that contained no provision for class arbitration and other language in the agreement "provides only for bilateral arbitration, there is no contractual basis for concluding the parties agreed to submit to class arbitration. Therefore, we conclude that the Arbitration Agreement does not authorize class arbitration." (*Id.* at \*3.) It went further to explicitly note: "[I]n light of *Stolt-Nielsen*, *supra*, 130 S.Ct. 1758 and *Kinecta*, *supra*, 205 Cal.App.4th 506, arbitration agreements silent on the issue of class arbitration nevertheless have the same effect [as arbitration agreements containing an express class waiver] of precluding class arbitration so long as there is no evidence that the parties agreed to class arbitration." (*Id.* at \*5.) (2) Although the Court strongly intimated that *Gentry* could not withstand *Concepcion*, it did not reach the issue because the plaintiff had not sustained its burden to make a factual showing under the *Gentry* test. (*Id.* at \*7.) The Court followed the other California cases finding the NLRB's *D.R. Horton* decision unpersuasive, and declined to follow it. (*Id.* at \*17.)

A fifth case, which does not involve employment claims, shows how effectively the United States Supreme Court's recent arbitration decisions have pushed California's appellate courts to temper, if not abandon, their hostility to arbitration. In *Caron v. Mercedes-Benz Financial Services USA, LLC* (June 29, 2012) 208 Cal.App. 4th 7, the Court of Appeal extended the reach of FAA preemption to class claims under California's Consumer Legal Remedies Act ("CLRA"). Relying on *Concepcion*, the Court held that "the FAA preempts the CLRA's anti-

waiver provision because the provision acts as an obstacle to the FAA’s intention of enforcing arbitration agreements according to their terms.” (*Id.* at 12.)

The consumer in *Caron* had entered into a sales contract with a Mercedes Benz dealer that included an arbitration provision by which the consumer gave up the “right to participate as a class representative or class member on any class claim [she might] have . . . including any right to class arbitration or any consolidation of individual arbitrations.” She filed a complaint for, among other things, violation of the CLRA, and included class claims for those violations. The CLRA authorizes a consumer to bring a class action on behalf of similarly situated consumers, to recover the same relief sought by the consumer. (Civ. Code § 1751(a).) It also provides: “Any waiver by a consumer of [its] provisions . . . is contrary to public policy and shall be unenforceable and void.” (Civ. Code § 1751.)

The *Caron* Court found “[n]o meaningful difference . . . between the CLRA’s class action prohibition and the *Discover Bank* rule. Both are state-law rules that prevent enforcement of an arbitration agreement according to its terms.” (*Id.* at 22.) Although plaintiff argued that the CLRA’s anti-waiver provision related to the CLRA class action right whether the waiver was placed in an arbitration provision or in another provision in a sales contract and therefore had nothing to do with arbitration, the Court concluded that the defendants “placed the waiver in the arbitration provision to prevent Caron from using class allegations to avoid arbitration altogether. Consequently, the provision is first and foremost an arbitration clause. It merely includes a class-action waiver to ensure the parties arbitrate their claims as agreed.” (*Id.* at 24.)

The Court relied heavily on *Concepcion*’s holding that “the FAA’s preemptive effect may extend even to grounds traditionally thought to exist at law or in equity for the revocation of any contract [] when those grounds have been applied in a fashion that disfavors arbitration. (*Id.* at p.1747.)” (*Id.* at 23 (internal quotes omitted).)<sup>3</sup>

### **III. Beware of Poorly Crafted Arbitration Provisions; California Courts Still Will Not Enforce Them.**

Although the courts in California are trending toward upholding class action waivers in arbitration clauses, they still do not hesitate to find an arbitration provision unconscionable where it is poorly drafted or fails to give an employee proper notice of its provisions. In *Sparks v. Vista Del Mar Child and Family Services* (July 30, 2012) 207 Cal.App.4th 1511, the appellate court held an arbitration provision in an employee handbook unenforceable as procedurally and substantively unconscionable, under the following circumstances:

1. The handbook had been “‘distributed’ to all employees,” and “included an arbitration provision in one of many clauses not prominently distinguished from the other clauses.” (*Id.* at 1519.)

<sup>3</sup> The *Caron* Court also commented that the plaintiff had not explained how requiring her to arbitrate her CLRA claims would prevent her from vindicating her substantive rights under the CLRA. (*Id.* at 25.) In light of *Concepcion*’s holding that a court may not interject its own public policy considerations into the analysis of whether FAA preemption applies (131 S.Ct. at 1747), this side-discussion by the *Caron* Court appears to be beside the point.

2. There was “no place for the employee to acknowledge” the arbitration clause in writing. (*Id.* at 1519.)

3. The language in the handbook suggested the handbook “was informational rather than contractual.” According to the Court, “merely agreeing to be ‘governed by the contents’ of the Handbook that contains ‘important information’ about defendant’s ‘general personnel policies and on [plaintiff’s] privileges and obligations’ – all of which could be unilaterally changed – did not constitute a contract and does not bind plaintiff to arbitration.” (*Id.* at 1520.)

4. The handbook expressly provided, “This Handbook is not intended to create a contract of employment . . . .” (*Id.* at 1522.)

5. The agreement to arbitrate was illusory, because (a) the employer reserved the right to unilaterally modify the handbook, and (b) the employer failed to provide a copy of the arbitration rules made applicable by the arbitration provision. (*Id.* at 1523.)

6. The arbitration provision “requires the employee to relinquish his or her administrative and judicial rights under the federal and state statutes”. (*Id.* at 1523.)

#### **IV. Conclusion**

Employers who carefully craft arbitration provisions with class-action waivers can take heart from the recent case law in California. The trend is clearly toward enforcing such provisions. But until the California Supreme Court has its say, it will be unclear whether the prior apparent judicial hostility to arbitration agreements in the employment area will return.