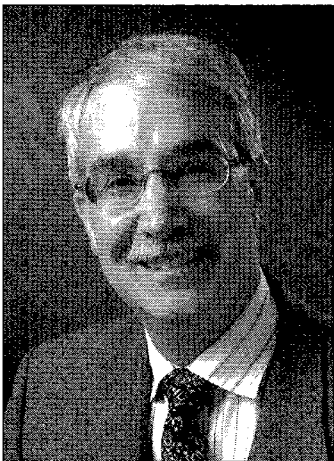


# Employee Relations LAW JOURNAL

## Employers Beware: California Courts Invalidate Employment Arbitration Clauses Unless They Are Mutual And Do Not Saddle Employees With Cost/Procedural Burdens

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*This article reviews recent California decisions examining employment arbitration agreements and summarizes what employers need to do in drafting arbitration agreements that will escape judicial invalidation in state court cases.*



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endorsing fewer, and saving others through use of severability principles.<sup>2</sup>

### ARMENDARIZ AND FEDERAL ARBITRATION ACT INTERPLAY

*Armendariz* is the starting point for analyzing the enforceability of employer-employee arbitration agreements in California. This decision established that an employee seeking to prove that an arbitration agreement is unconscionable must prove both procedural and substantive unconscionability in order to prevail. Usually, procedural unconscionability is easy to prove by the employee, because the employer insisted on the

Although no statistics are available on their frequency of use, many employment relationships in California are subject to arbitration agreements. These agreements have a variety of nuances, but all hope to remove a suing (usually former) employee's ability to litigate before a jury and to force the full expenses of court litigation on the employer. Starting with the groundbreaking decision of *Armendariz v. Foundation Health Psychcare Services, Inc.*,<sup>1</sup> California state courts systematically have been examining employment arbitration agreements with mixed results, invalidating many,

arbitration agreement as a condition of employment or put substantial leverage on the employee to accept it under consequences of work reprisals. The main focus is on the employee demonstrating procedural unconscionability, with *Armendariz* setting the beacon standards in the employment arena, which it characterized as "minimum standards of fairness in arbitration." These requirements are:

- A neutral arbitrator;
- Adequate discovery;
- All types of relief otherwise available in court are subject to arbitration (examples: no damage limitations and no waiver of statutory claims such as those under the California Fair Employment and Housing Act (FEHA));
- A written arbitration award that permits limited judicial review;
- Access to the arbitration forum not conditioned on employees paying either unreasonable costs or any arbitrator's fees or expenses; and
- Bilaterality of a nature by which both employer and employee must submit all arbitrable claims to arbitration.<sup>3</sup>

*Armendariz* also refused to sever the unfair terms of the arbitration provision, finding that multiple terms were offensive and that the defects demonstrated an employer's intent to keep the playing field tilted in its favor.

Many employers have tried to nullify these fairness standards

by arguing that they are preempted by the Federal Arbitration Act (FAA). This argument consistently has been rejected in California decisions. The reason is that the *Armendariz* fairness standards are analogous to unconscionability defenses applicable to all contracts rather than just contracts with arbitration provisions.

## LITTLE

In *Little v. Auto Stiegler, Inc.*,<sup>4</sup> the California Supreme Court built upon its analysis in *Armendariz* in several respects. Here is a synopsis of the *Armendariz* refinements:

- Wrongful termination claims in violation of public policy, like FEHA statutory claims, cannot be exempted from *Armendariz*' fairness standards;
- An agreement allowing either party to appeal an arbitration award more than \$50,000 to a second arbitrator was unenforceable because it was tilted too far in the employer's favor;
- Legal formalities in an arbitration agreement—requiring the arbitrator to adhere to pleading, law-and-motion and evidentiary civil litigation standards and to rely on only legal standards in rendering a decision—does not make the agreement unconscionable in nature; and
- Silence on allocation of arbitration courts in arbitration agreements is not suspect but means the employer must bear the arbitration forum costs.

*Little*, however, did not refuse to enforce the arbitration agreement because only one provision—the \$50,000 appeal section—was substantively unconscionable. The Supreme Court severed out this offending part and ordered the employee to arbitration.

## MERCURO

*Mercurio v. Superior Court*,<sup>5</sup> involved an arbitration agreement signed by an employee under extreme employer economic pressure: the employee would be “cut off” and made to “pay big time” after relocating from Florida to California if the clause was not agreed to. Because the employee established procedural unconscionability based on a “take-it-or-leave-it” scenario, the validity of the arbitration agreement depended on whether the employer could procedurally pass the *Armendariz* fairness test. The *Mercurio* clause failed because it

- Excluded from arbitration injunctive and equitable relief for intellectual property, unfair competition and trade secret violations, claims which unfairly favored employers who would be able to more frequently litigate these expensive exempt claims in court;
- Did not allow the employee to participate in the arbitrator selection process; and

- Improperly required the employee to pay one-half of arbitration costs in order to vindicate statutory claims under the Labor Code (employer misrepresentations inducing one to relocate for a job and discrimination for participating in children's school activities).

However, *Mercurio* did not find the arbitration agreement offensive in (1) having the employee arbitrate before the National Arbitration Forum, a venue where employer might have benefits as a “repeat player”; and (2) limiting discovery to 30 requests inclusive of three depositions unless good cause for more discovery could be shown before the arbitrator. The *Mercurio* court refused, however, to sever the offending parts of the arbitration agreement, finding the employer's threats and three *Armendariz* defects too much to stomach.

## DUNG

*Armendariz* was applied and resulted in invalidation of an arbitration agreement in *Dung v. Inter-Con Security Systems, Inc.*<sup>6</sup> Like *Mercurio*, the *Dung* court found the arbitration clause had three strikes against it under *Armendariz*:

- A strict, employer-imposed one-year statute of limitations (which precluded tolling) deprived the employee of the remedies normally enjoyed under the FEHA such as the benefit of the continuing violation doctrine (which delays the running of the FEHA limitations statute);
- The requirement that employee equally share in arbitration costs, up to a 35% cap on the amount at issue, violated the cost-shifting ban in *Armendariz*; and
- The exclusion of employer's injunctive and equitable claims, of all types, was too one-sided in employer's favor and broader than the clause found wanting in *Mercurio*.

Despite the existence of a severance “savings” clause in the employment contract, *Dung* found the “three strikes” too excessive for purposes of trying to reform the “unconscionable-permeated” arbitration clause.

## O'HARE

Another arbitration clause was struck down in *O'Hare v. Municipal Resource Consultants*.<sup>7</sup> The clause was found adhesive given the absence of any “give and take” in negotiations, which meant the dispositive analysis was whether it met *Armendariz*' fairness standards. The clause failed for two reasons, enough to doom it on unconscionability grounds:

- Allowing employer to seek injunctive and equitable relief in court, while requiring employee to arbitrate all its claims (extensively citing *Mercurio* in finding a lack of mutuality); and

- Adopting American Arbitration Association (AAA) cost rules which required equal sharing of arbitration costs and no mention of employer agreeing to any other allocation of costs.

There are two interesting side aspects to *O'Hare*. Although the employer offered on appeal to bear all arbitration costs, the appellate court found this was too late – the clause was unconscionable at the time it was agreed to at the start of the employment relationship. Employee also argued that the clause denied pre-arbitration discovery in derogation of *Armendariz*. Although conceding that it did, employer countered that the contract incorporated AAA rules which by time of suit did allow for discovery. The *O'Hare* court did not have to face this issue because of the other *Armendariz* infirmities, but did suggest that the serendipitous change in AAA rules likely did not rescue the employer on the discovery denial issue.

### **MCMANUS**

One of the few pro-employer decisions, *McManus v. CIBC World Markets Corp.*,<sup>8</sup> found only one *Armendariz* violation and saved the arbitration agreement by severing out the bad terms.

After concluding that broker employment agreements requiring resort to SEC mandatory arbitration were not automatically unconscionable, the *McManus* court addressed whether the arbitration clause offended *Armendariz*. It determined the only flaw was the requirement that employee pay a \$500 deposit and per daily hearing fee, but this could be severed out so that arbitration could proceed.

In reaching this result, *McManus* found other features of the arbitration clause were acceptable. The SEC procedure for arbitrator selection allowed for employee participation (unlike *Mercuro*), permitted the employee to strike certain candidates, and allowed for disqualification on conflict grounds – features found to be fair by the appellate court. Nothing was found suspicious in requiring that the arbitrator be a lawyer or a retired judge. No discovery was denied to the employee, because the SEC procedures allowed for extensive document exchanges and the arbitration clause allowed for depositions at the request of any party. SEC procedures also required a written statement of reasons for the award, coupled with maintenance of a verbatim transcript of proceedings, so as to meet the decisionmaking *Armendariz* requirement.

This case counsels that employers should review the rules which they select to govern the arbitration process; the SEC broker rules used in *McManus* were fair to both employee and employer.

### **WILSON**

Again, an employer lost its right to compel arbitration in *Wilson v. Bally Total Fitness Corp., Inc.*<sup>9</sup> Like *Mercuro*, the *Wilson* provision wrongfully required an employee to share arbitration costs for most claims and improperly exempted injunctive and equitable relief sought by the employer. As in *Dung*, the employer tried to permissibly truncate the limitations period for an

employee to bring claims. These three problems doomed employer's effort to enforce the arbitration clause.

However, a fourth defect was also present. Employer tried to limit certain statutory penalties to the amount of one year of employee's gross cash compensation. This limitation was listed as another basis upon which to find the arbitration clause invalid in nature.

### **PITZEN**

Another arbitration clause contained in a trade secret agreement signed by an employee failed *Armendariz* standards in *Pitzen v. Veritas Software Corp.*<sup>10</sup> Three strikes invalidated the clause, with the appellate court unwilling to save it through severance of the offending terms. The defects were:

- The arbitration clause erroneously provided that the employee could be liable for arbitration costs, the employer's attorneys' fees, and the employer's expert witness fees if employee lost the arbitration, a cost disincentive inconsistent with *Armendariz*;
- The clause was still one-sided in stating that both employer and employee could seek injunctive relief because employers were the overwhelming candidates likely to seek injunctive relief; and
- The provision allowing the employer to seek permanent injunctive relief (an immediate injunction) in court, rather than in arbitration, was slanted too far in employer's favor.

*Pitzen*, however, was pro-employer on two points. First, it found that "final and binding" arbitration language in the ADR clause did not necessarily preclude limited judicial review under C.C.P. sections 1286.2 and 1286.6. Second, incorporation of AAA rules on costs – in disagreement with *O'Hare* – did not violate *Armendariz* because AAA rules held that the split-expense presumption did not apply if the law otherwise dictated (as in *Armendariz*). On this second point, *Pitzen* agrees with *Fittante v. Palm Springs Motors, Inc.*,<sup>11</sup> which found incorporation of AAA cost rules was inoffensive, and parts company with *O'Hare*, which held AAA split-cost rules violated *Armendariz*.

### **CONCLUSION**

Unless careful attention is given to the *Armendariz* fairness factors, many employment arbitration agreements will be found invalid. California courts have shown a proclivity to be pro-employee and only honor arbitration clauses which are bilateral, fair, preserve employee remedies, and contain due process protections.

What lessons are there for employers in light of California case law? Actually, quite simple. Based upon the decisions to date, the following menu of "do's" and "don'ts" should be used by employers when drafting arbitration agreements in employment contracts:

- The agreement must provide for a neutral arbitrator, contractually specifying or incorporating private alternative dispute resolution (ADR) group rules that (1) provide for employee participation in the arbitrator selection process, and (2) provide for arbitrator disclosure of conflict/bias factors;
- The agreement cannot deny adequate discovery, providing for documentary exchanges and an arbitrator's ability to regulate deposition taking;
- The agreement must contractually require the arbitrator to render a written award complete with a statement of reasons for the decision;
- The agreement cannot require the employee to bear any costs over those incurred in a court case or, alternatively, can remain silent on costs as long as the agreement does not incorporate any ADR rules which have a different cost reallocation effect;
- The agreement must specify that all form of damages, including punitive damages and statutory penalties, are allowable and cannot place maximum caps on potential recoveries;
- The agreement must require both employer and employee to submit all claims against the other, including discrimination, statutory Labor Code, and wrongful termination claims, to arbitration, not carving out any injunctive or equitable claims;
- The agreement should not contain elevated appellate procedures of a biased nature; and
- The agreement should contain severance "savings" language so that a slightly defective provision can be salvaged by excising the offensive portions.

Words of caution: Assembly Bill 1715, under consideration by the California Legislature this session, would render unenforceable any post-January 1, 2004 arbitration agreement between an employer and employee waiving FEHA rights (such as the right to court litigation) unless the employee did so knowingly, voluntarily, and not as a condition of employment or continued employment. AB1715 was not enacted into law, but legislative developments need to be monitored to see if past proposals change the legal landscape.

Employers wanting mandatory arbitration agreements should monitor court decisions and legislative developments, having experienced employment counsel prepare or review any proposed arbitration agreements before they are implemented.

## NOTES

1. 24 Cal. 4th 83 (2000).
2. This article does not cover federal court (Ninth Circuit) treatment of arbitration clauses, which have invalidated arbitration agreements even more than state courts.
3. *Armendariz, supra*, 24 Cal. 4th at p. 102.
4. 29 Cal. 4th 1064 (2003).
5. 96 Cal. App. 4th 167 (2002).
6. 2002 WL 984800 (2002) (unpublished).
7. 107 Cal. App. 4th 267 (2003).
8. 109 Cal. App. 4th 76 (2003).
9. 2003 WL 21398324 (2003) (unpublished).
10. Case No. A100181 (1st Dist., Div. 3 8/29/03 (unpublished))
11. 105 Cal. App. 4th 708, 719 (2003)

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