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Management Alert

California Supreme Court Disapproves of Class Action Arbitration Waivers in the Employment Context

The California Supreme Court narrowed the circumstances under which class action waivers in an employment arbitration agreement can be enforced. In *Gentry v. Superior Court (*2007) (S141502) the Court concluded that class action waivers in employment arbitration agreements should not be enforced if a trial court determines that class arbitration would be more effective than individual arbitration in vindicating employee rights. The Court enumerated factors to consider, including whether individual recovery amounts sufficiently incentivized litigation, the risk of retaliation to employees, and the likelihood that other employees are unaware of alleged illegal conduct. Although the Court's decision was limited to wage and hour violations, it will likely have much broader implications.

The Court also held that in determining whether an arbitration agreement was unenforceable, procedural unconscionability could be found in employment arbitration agreements even when employees are given an opportunity to opt-out of arbitration. This is a marked departure from federal court authority finding that an opportunity to opt out was almost a complete guarantee that an agreement is not procedurally unconscionable. The Court reiterated that for an agreement to be unenforceable due to unconscionability, it must be both substantively and procedurally unconscionable, but not necessarily to the same degree.

Background on the Class Action Waivers

The issue of the class action waiver begins with *Discover Bank v. Superior Court* (2005) 36 Cal.4th 148. In *Discover Bank*, a plaintiff brought a class action claiming that the bank had not adequately disclosed a $29.00 late fee charged to credit card holders. However, an amendment to an arbitration policy contained in a mandatory pre-dispute credit card agreement contained a provision precluding class actions. The California Supreme Court found the waiver was an unconscionable exculpatory provision (exempting one from responsibility for fraudulent or unlawful conduct).

In early 2006, California's Second District Court of Appeal applied *Discover Bank* in the employment context. In *Gentry v. Superior Court* (2006) 135 Cal.App.4th 944, the plaintiff filed a class complaint charging that his employer, Circuit City, misclassified its customer service managers as exempt when they should have been considered non-exempt employees and paid for overtime. Circuit City sought to compel arbitration pursuant to an arbitration agreement that contained a class action waiver. The agreement also gave employees 30 days to opt out of arbitration.

Plaintiff claimed that the agreement was both substantively and procedurally unconscionable. Although an opportunity to opt out is not required, it has been almost a complete guarantee that an agreement is not procedurally unconscionable. Following this reasoning, and based largely on the opt out clause, the Court found the agreement was not procedurally unconscionable. And, applying *Discover Bank,* the Court held that the agreement, and the class action waiver in particular, was not substantively unconscionable because it was not being used in a setting where disputes predictably involved small amounts of damages.

Less than a year after deciding *Gentry*, the Second District Court of Appeal addressed this issue again in *Konig v. U-Haul Co.* (2006) 145 Cal.App.4th 1243. In *Konig*, the plaintiff filed a proposed class action alleging that his employer, U-Haul, failed to pay its employees overtime and accrued vacation, and did not allow its employees to take meal and rest breaks. U-Haul moved to compel arbitration based on an arbitration agreement that contained a class action waiver and did not give employees an opportunity to opt-out. The Second District affirmed the trial court's order compelling arbitration and dismissing plaintiff's putative class claims. On February 18, 2007, the California Supreme Court accepted review of the *Konig* case deferring further action pending disposition of *Gentry*.

The Decision in Gentry

Class Action Waiver

The California Supreme Court concluded, "at least in some cases, the prohibition of class wide relief would undermine the vindication of the employees' unwaivable statutory rights and would pose a serious obstacle to the enforcement of the state's overtime laws." The Court stated that " class arbitration waivers should not be enforced if a trial court determines, based on the factors discussed below, that class arbitration would be a significantly more effective way of vindicating the rights of affected employees than individual arbitration."

The Court also was careful not to expressly issue an outright ban on class action waivers and enumerated three factors for courts to consider in determining whether a specific waiver was exculpatory and substantively unconscionable. As the first factor, the Court followed the reasoning in *Discover Bank* and looked at the amount of an individual's recovery. It provided some insight into what amount may be sufficient recovery to incentivize individual lawsuits and have the clause not be found exculpatory. It cited as an example *Bell v. Farmers Ins. Exchange* (2004) 115 Cal.App.4th 715, indicating that an award as large as $37,000 would not be "ample incentive" but noted that larger awards recoverable in age discrimination suits, with a median value of $269,000, would sufficiently incentivize individual lawsuits. However, the Court later concluded, concurring with *Bell*, that "class actions may be needed to assure the effective enforcement of statutory policies even though some claims are large enough to provide an incentive for individual action."

The Court rejected Circuit City's argument that recovery of attorney's fees bolstered an individual's incentive to bring claims. It stated: "Even assuming that such attorney fees were equally available in arbitration, employees and their attorneys must weigh the typically modest recovery, and the typically modest means of the employees bringing overtime lawsuits, with the risk of not prevailing and being saddled with the substantial costs of paying their own attorneys."

The second factor in assessing class actions would be risk of retaliation. The Court used Circuit City's statistical evidence showing that a significant number of claims had been filed with DLSE under Labor Code section 98.6, which it presented to show strong enforcement, to support Gentry's position that retaliation for filing wage claims is rampant. It also rejected Circuit City's arguments that statutes rendering retaliation unlawful would prevent employers from retaliating more effectively than the class mechanism and that administrative enforcement by the DLSE mitigated for the loss of the class mechanism.

The third factor was the likelihood that other employees may be unaware of illegal employer conduct. With respect to wage and hour claims, the Court reasoned that immigrants with limited English language skills, may be unfamiliar with the overtime laws or due to the transient nature of their work, may not be in a position to pursue individual litigation against a former employer. The Court further commented that even better educated employees may not be aware of the nuances of overtime laws with their sometimes complex classifications of exempt and nonexempt employees.

With respect to whether a class action waiver would automatically render an arbitration agreement substantively unconscionable, the Court concluded that: "severance is particularly appropriate in the case of class arbitration waivers because, unlike limitations on remedies or other limitations that are invalid on their face . . . such waivers will only be invalidated after the proper factual showing, as discussed above."

Opt Out Provision

As a preliminary matter, the Court rejected Gentry's argument that his signature on the notice of acknowledgment of receipt of the dispute resolution policy and failure to exercise his right to opt out did not constitute assent to the agreement. It then addressed procedural unconscionability and Circuit City's 30-day opt out provision. The Court held that in determining whether an arbitration agreement was unenforceable based on unconscionability, procedural unconscionability could be found in employment arbitration agreements even when employees are given an opportunity to opt-out of arbitration.

The Court acknowledged significant federal authority to the contrary. In reaching this conclusion, it relied on an employee's understanding that arbitration was the employer's preference, resulting in pressure to not opt out. The Court was also critical of the lack of disclosure in Circuit City's agreement of provisions it had modified to be less advantageous to the employee, such as a shortened limitations period and restrictions on recovery of putative damages and attorney's fees. The Court concluded: "The lack of material information about the disadvantageous terms of the arbitration agreement, combined with the likelihood that employees felt at least some pressure not to opt out . . . leads to the conclusion that the present agreement was, at the very least, not entirely free from procedural unconscionability."

What *Gentry* Means for Employers

This decision significantly limits an employer's ability to use class action waivers in employment arbitration agreements. Although the Court in *Gentry* was careful to limit its holding to the wage and hour context, the factors it enumerated will likely extend the holding to other areas of employment litigation as well. Moreover, it would be risky and complicated to draft an agreement that sufficiently limited the waiver. Employers should also review their arbitration agreements for substantive and procedural unconscionability with the understanding that an opt out provision is no longer a complete guarantee that an agreement is not procedurally unconscionable.

If you have any questions concerning this Management Alert, please contact the Seyfarth Shaw LLP attorney with whom you work or any labor and employment attorney on our website www.seyfarth.com.

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