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One Minute Memo®

"Don't Mess with Texas" (Choice of Law Provisions)

By David D. Kadue and Andrew C. Crane

Many companies doing business in California have implemented arbitration agreements for resolving disputes with their employees. Companies headquartered in states other than California often prefer to use the law of their own state as the law to govern their contracts. In the context of arbitration, a valid choice of law can tell the arbitrator what law to apply.

In *Pinela v. Neiman Marcus Group, Inc.*, however, the California Court of Appeal found that an arbitration agreement between Texas-based Neiman Marcus and a California-based employee was unconscionable because the agreement designated Texas law as the law to apply. This holding should cause non-California employers pause prior to implementing an arbitration agreement that chooses a law other than California's for disputes involving California employees.

The Facts

The plaintiff, Juan Carlos Pinela, had worked in California for Neiman Marcus Group, Inc. ("NMG"), which is headquartered in Texas. Pinela brought a class action suit against NMG in California state court, claiming violations of California wage and hour law.

NMG moved to compel arbitration of these claims under the arbitration agreement that Pinela had signed as a condition of employment. The trial court ultimately denied the motion on the ground that the arbitration agreement was illusory.

NMG appealed, arguing (1) the agreement was not illusory, because the agreement delegated the decision of whether the agreement was enforceable to the arbitrator; and (2) the agreement was enforceable.

The Appellate Court Decision

The Court of Appeal upheld the trial court's decision that the agreement was unenforceable, but on different grounds. Rather than finding the agreement illusory, the Court of Appeal found that the agreement was unconscionable.

The Court of Appeal analyzed whether the delegation clause itself was unconscionable. This turned on the clause designating Texas law as governing the agreement, both on substantive issues (i.e., whether Pinela's claims had merit) and other issues, including whether the agreement was enforceable.

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Focusing first on procedural unconscionability—how the agreement was presented to Pinela—the Court of Appeal agreed with Pinela that the agreement was a contract of adhesion because it was a condition of his employment, and examined the choice-of-law clause. This clause designated Texas law as controlling for state claims and Fifth Circuit law as controlling for federal claims. The Court of Appeal found that this clause was so "obscure" and "difficult to comprehend" that Pinela could not possibly have understood its meaning. For these reasons, the Court of Appeal found that there was procedural unconscionability.

The Court of Appeal next addressed substantive unconscionability, which focuses on the fairness of the agreement's terms. Pinela argued that, because Texas does not recognize an unconscionability defense, the choice of law restricted his legal arguments under California law. The Court of Appeal agreed, reasoning that when the weaker party to an adhesion contract can show the agreement is unconscionable under California law, a contractual provision requiring the application of a different state's law (i.e., the choice-of-law clause) is itself unenforceable. Accordingly, because the choice-of-law clause was "inextricably bound up" with the provision delegating interpretive authority to the arbitrator, both clauses were unenforceable.

After determining that California law must apply, the Court of Appeal determined that the agreement as a whole was unconscionable: Texas state law does not recognize a private cause of action for enforcement of wage and hour protections for employees, and thus would block Pinela from pursuing his claims. The agreement also had other unconscionable provisions: (1) a requirement that the arbitrator reside in Texas, (2) permitting NMG to recover fees and costs it could not recover under California law, and (3) imposing a one-year statute of limitations for all claims, regardless of whether they had a longer limitations period under California law. For these reasons, the Court of Appeal found that the agreement was unconscionable, and thus unenforceable.

What *Pinela* Means For Employers

Pinela is a cautionary tale for any non-California company seeking to implement an arbitration agreement with California-based employees. Any choice-of-law clause designating a different state's law will be closely scrutinized, and may fail to pass muster if it results in procedures less favorable to the employee than those provided by California law. Companies seeking to implement agreements with non-California choice of law provisions should make sure that they are not drafted in a manner that would render them subject to attack.

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