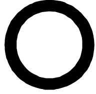

ORRICK

CONFIDENTIAL MEMORANDUM
ATTORNEY-CLIENT PRIVILEGED
ATTORNEY WORK PRODUCT

To	Company
From	Orrick, Herrington & Sutcliffe LLP
Date	May 18, 2011
Re	Class Action Waivers in Arbitration Agreements

INTRODUCTION

You requested that, in light of the United States Supreme Court's recent decision in *AT&T Mobility v. Concepcion*, No. 09-893, 2011 U.S. Lexis 3367 (U.S. April 27, 2011) ("*Concepcion*"), we examine the use of arbitration provisions in employment agreements as a method of cutting off class/collective wage-and-hour claims through class action waiver clauses. In particular, you requested that (1) we examine the current state of the law regarding the use of class action waivers in arbitration agreements in light of *Concepcion*; and (2) we examine whether, in light of *Concepcion*, the Company can avoid class actions through the implementation of an arbitration agreement with a class action waiver. Below we set forth our analysis of these issues.

EXECUTIVE SUMMARY

Though the enforceability of class action waivers in arbitration agreements has historically varied by jurisdiction and the type of claim at issue, *Concepcion* has the potential to render most such waivers valid and enforceable in the wage-and-hour context. In holding that the Federal Arbitration Act ("FAA") preempts state-law unconscionability rules that invalidate class action waiver provisions and thereby "manufacture" class arbitration, the Supreme Court used forceful language that arguably invalidates classwide arbitration altogether – regardless of the area of law – unless it is agreed to by contracting parties. *Concepcion* therefore constitutes a promising basis for including arbitration clauses with class action waivers in the Company's employment agreements.

However, *Concepcion* is sure to come under attack from various angles, including in the courts, before administrative agencies, and potentially in Congress. Indeed, despite the broad and forceful language of *Concepcion*, its preemption holding arose in the limited context of a state-law unconscionability rule, and the plaintiffs' bar will advance multiple arguments and initiatives designed to confine its holding as much as possible in this regard. Therefore, while we view *Concepcion* as an extremely helpful decision that has the potential to create a paradigm shift in the

context of arbitration agreements with class action waivers, its full impact will not be known until it receives thorough treatment in the courts.

In light of these considerations, while *Concepcion* provides the Company with its best support yet for utilizing arbitration agreements with class action waivers as a method of cutting off class action exposure, and while the Company could in fact avoid class action exposure in light of *Concepcion*, the lingering uncertainties regarding its future application counsel against relying too heavily on *Concepcion* at this point. As a result, were the Company to implement an arbitration agreement with a class action waiver clause in light of *Concepcion*, we would recommend that it do so in relatively conservative fashion in order to maximize the chances of its enforcement.

ANALYSIS

A. Post-*Concepcion* Enforceability Of Class Action Waivers In Arbitration Agreements

The enforceability of class action waivers in arbitration agreements has typically depended on the type of claims asserted and the jurisdiction of the action. Thus, for example, whereas class action waivers in employment arbitration agreements have historically been held invalid under California law, they have been held valid and enforceable under the laws of New York and Texas. Similarly, in cases asserting proposed collective actions under the federal Fair Labor Standards Act ("FLSA"), the enforceability of such waivers has varied by circuit.

The Supreme Court's recent decision in *Concepcion*, however, has the potential to effect sweeping change with regard to the validity of class action waivers in arbitration agreements – at least with regard to arbitration agreements that are subject to the FAA.[1] In holding that the FAA preempts California's common-law rule that class action waivers are invalid in most consumer contracts, the Court in *Concepcion* used forceful language and did not limit its analysis to the consumer class action context. As a result, *Concepcion* at minimum provides a legitimate and forceful new basis for implementing arbitration provisions with class action waivers into employment agreements.

Below we review the *Concepcion* decision and analyze its potential impact on the validity of class action waivers in arbitration agreements going forward.

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[1] Because the test for whether an employment-related arbitration contract is subject to the FAA hinges on whether the contract "evidence[s]" a transaction involving commerce (*See Perry v. Thomas*, 482 U.S. 483, 489 (1987)), it is widely understood that most employment-related arbitration agreements are subject to the FAA. *See also Circuit City Stores v. Adams*, 532 U.S. 105, 109-10 (2001) (holding the FAA's exemption of certain employment contracts from its coverage only extends to employment contracts involving transportation workers).

1. ***Concepcion***

Concepcion has the potential to settle much of the uncertainty regarding the validity of class/collective action waivers in arbitration agreements, including in the context of employment-related arbitration agreements. In striking down California's rule prohibiting class action waivers in most consumer contracts, it continued the Supreme Court's trend toward upholding arbitration agreements and emphasizing, above all else, the agreement of the parties to arbitration contracts. Indeed, the Supreme Court issued its decision in *Concepcion* only a year after its ruling in *Stolt-Neilsen S.A. v. Animalfeeds International, Corp.*, 130 S. Ct. 1758 (2010), in which the Court restricted the imposition of classwide arbitration where a valid arbitration agreement is silent on the issue.

Concepcion involved a proposed class action asserting claims of fraud and false advertising stemming from Plaintiffs' purchase of cellular telephone service from AT&T. Plaintiffs claimed that they purchased the service having relied on advertising by AT&T promising a "free" telephone, only to discover that they were later required to pay sales tax on the retail value of the phone. The phone service agreement included a broadly-worded arbitration provision that required that any disputes between AT&T and the customer be submitted to arbitration, and prohibited customers from bringing any claims in a class action or other representative proceeding. Upon Plaintiffs' filing of the lawsuit, AT&T moved to compel arbitration.

The district court denied AT&T's motion to compel arbitration, holding that the arbitration agreement's class action waiver was unconscionable and therefore unenforceable under *Discover Bank v. Superior Court*, 36 Cal.4th 148 (2005), a California Supreme Court decision that, in effect, held most class action waivers in consumer contracts to be unconscionable.[2] The district court's decision in this regard is notable, as the district court simultaneously observed that the terms of the arbitration agreement were so favorable to Plaintiffs that they would likely be better off proceeding through arbitration than as plaintiffs in a class action. Indeed, as the Court noted, the arbitration provision provided, among other things, that (1) AT&T was required to pay all arbitration costs for non-frivolous claims; (2) arbitration was to take place in the county of the customer's billing address; (3) as to claims for $10,000 or less, the customer could choose whether the arbitration would proceed in person, by phone, or based on submissions; and (4) AT&T was unable to seek reimbursement for its attorneys' fees, and, in the event the customer received an arbitration award in an amount greater

[2] The so-called *Discover Bank* rule derived first and foremost from the notion that, in cases involving small potential individual recoveries, plaintiffs and plaintiffs' attorneys were unlikely to pursue individual actions, and absent the class action mechanism, businesses could go unchecked in their abuses. The *Discover Bank* rule thus provided that "[w]hen the waiver is found in a consumer contract of adhesion in a setting in which disputes between the contracting parties predictably involve small amounts of damages, and when it is alleged that the party with the superior bargaining power has carried out a scheme to deliberately cheat large numbers of consumers out of individually small sums of money, then…the waiver becomes in practice the exemption of the party 'from responsibility for [its] own fraud, or willful injury to the person or property of another.' Under these circumstances, such waivers are unconscionable under California law and should not be enforced." *See* 36 Cal. 4th at 162-63 (internal citations omitted).

than AT&T's last settlement offer, AT&T would be required to pay a $7,500 recovery fee and double the amount of the customer's attorney's fees.

In affirming the district court, the Ninth Circuit held that the class action waiver at issue was "exculpatory" and void as a matter of public policy because it protected AT&T against all types of class actions. The Ninth Circuit further found that the FAA did not preempt the so-called *Discover Bank* rule that most class action waivers in consumer contracts are unconscionable. In support of this holding, the Ninth Circuit relied on Section 2 of the FAA, which permits arbitration agreements to be invalidated "upon such grounds as exist at law or equity for the revocation of any contract." The Ninth Circuit reasoned that the *Discover Bank* rule fell within the ambit of Section 2 because it constituted the California Supreme Court's "refinement" of California's unconscionability doctrine – a ground existing under California law for the revocation of contracts – in the context of consumer class action waivers.

The Supreme Court reversed, and, in a 5-4 decision authored by Justice Scalia, held that the FAA preempts the *Discover Bank* rule. The Court emphasized that "[t]he overarching purpose of the FAA…is to ensure the enforcement of arbitration agreements according to their terms so as to facilitate streamlined proceedings," and that the FAA reflects a "liberal federal policy favoring arbitration agreements, notwithstanding any state substantive or procedural policies to the contrary." In light of the purposes and policies behind the FAA, the Court further found that the *Discover Bank* rule's prohibition of class action waivers presented "an obstacle to the accomplishment and execution of the full purposes and objectives" of the FAA.

The Court rejected the claim that the *Discover Bank* rule constituted a "ground…at law or equity for the revocation of any contract" under Section 2 of the FAA. In doing so, the Court drew an important distinction between "generally applicable" contract defenses – which Section 2 allows to be utilized to invalidate arbitration agreements – and "state law rules" (such as the *Discover Bank* rule) that employ such "generally applicable" contract defenses in a manner that specifically targets particular types of contracts such as arbitration agreements. The Court held that such "state law rules" conflict with the FAA's purpose of ensuring the enforcement of arbitration agreements according to their terms because they inevitably fail to place arbitration agreements "on equal footing" with other types of contracts.[3]

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[3] Justice Thomas wrote a separate concurring opinion. Although he agreed with the majority's conclusion, he reached his decision based on a strictly textual interpretation of the FAA, opining that the only grounds for revocation of an arbitration agreement under section 2 of the FAA are those concerning formation of the arbitration agreement, such as fraud, duress, or mutual mistake, and not other contract defenses, such as defenses based on public policy. Because the *Discover Bank* rule was ultimately premised on public policy-based defenses rather than defenses relating to "the making of the arbitration agreement," Justice Thomas noted, it did not concern the formation of the agreement. Thus, according to Justice Thomas, the *Discover Bank* rule could not be a basis for revocation of an arbitration agreement under the FAA. Interestingly, Justice Thomas's concurring opinion has caused at least one court to raise the question of the import of *Concepcion* in light of its "fragmented" rationale. *See Sheen et al. v. Chuck Lorre et al.*, No. SC-111794, California Superior Court, County of Los Angeles.

In the context of this discussion, the Court strongly emphasized the difficulties of implementing class arbitration procedures in arbitration agreements that are, by their terms, "bilateral." As the Court observed, "[c]lasswide arbitration includes absent parties, necessitating additional and different procedures…involving higher stakes," "[c]onfidentiality becomes more difficult," and "arbitrators are not generally knowledgeable in the often-dominant procedural aspects of certification, such as the protection of absent parties." The Court thus concluded that "manufactured" class arbitration is inconsistent with – and preempted by – the FAA because (1) it makes the arbitration "slower, more costly, and more likely to generate procedural morass than final judgment"; (2) it requires the very procedural formality that bilateral arbitration is intended to minimize; and (3) it "greatly increases risks to defendants" and is "poorly suited to the higher stakes of class litigation" due to the inherent risk in arbitration that errors go uncorrected due to the lack of an appeals process. As the Court noted, "[r]equiring the availability of classwide arbitration interferes with the fundamental attributes of arbitration and thus creates a scheme inconsistent with the FAA."[4]

2. The Impact Of *Concepcion*

Concepcion constitutes the most promising basis yet for including arbitration clauses with class action waivers in the Company's employment agreements, and is especially promising in the wage-and-hour context. Though the Court's decision pertained to a consumer contract, the rationale supporting its holding was generally worded and not limited to the consumer contract context, and was overtly hostile to the class action process. Indeed, because the *Concepcion* Court drew such a stark contrast between classwide arbitration and the dual purposes of the FAA of enforcing the terms of arbitration agreements and promoting efficiency, it is not unreasonable to interpret its decision as generally prohibiting the imposition of class procedures into arbitration agreements that are expressly bilateral. As the Court flatly noted, "[s]tates cannot require a procedure that is inconsistent with the FAA, even if it is undesirable for unrelated reasons."[5]

Concepcion also is notable because of its potential impact on state-law rules that – while not specific to class action waiver provisions – nonetheless impose standards that are specific to arbitration agreements in general. In California, for example, since 2000 arbitration agreements in employment contracts have been subject to the unconscionability and public policy standards set

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[4] In this context, the Court's four dissenting Justices strongly emphasized the importance of class proceedings to the prevention of small-dollar claims from "slipping through" the legal system. The majority, however, reiterated the importance of not requiring a procedure that is inconsistent with the FAA, and highlighted the arbitration agreement's pro-consumer provisions, which made it "most unlikely" that claims such as Plaintiffs' would not be resolved.

[5] Indeed, by squarely rejecting California's *Discover Bank* rule in such broad strokes, *Concepcion* could invalidate *Gentry v. Superior Court*, 42 Cal. 4th 443, 463 (2008), which (1) has served as the basis for other California decisions invalidating class action waivers in employment agreements; and (2) relied heavily on *Discover Bank* in holding a class action waiver in an employment arbitration agreement to be unenforceable.

forth in *Armendariz v. Foundation Health Psychare Servs., Inc.*, 24 Cal. 4th 83 (2000) and its progeny. Together, these standards have imposed significant restrictions on the ability of employers to require arbitration in employment agreements. In light of *Concepcion*, however, the validity of these standards is in question. Indeed, though *Concepcion* does not uniformly ban states from imposing limitations on arbitration agreements, it does restrict them from utilizing "generally applicable" contract defenses in a manner that targets or discriminates against arbitration agreements, or that otherwise fails to put arbitration agreements "on equal footing" with other contracts. *Armendariz* and its progeny are therefore potentially problematic to the extent that they articulate unconscionability standards pertaining specifically to arbitration agreements. Though we would still recommend that the Company adhere to the *Armendariz* standards should it decide to add mandatory arbitration clauses to its employment contracts, the impact of *Concepcion* on the validity of these and other similar standards is likely to receive further treatment in the courts and will be an issue worth monitoring.

The broader impact of *Concepcion*, including the precise scope of its preemption holding, also of course remains to be determined. Given *Concepcion's* significance and its potential to be a "game-changer" in the area of class action waivers, it is inevitable that more employers will implement class action waivers in their employment agreements and more motions to compel arbitration will be filed in the courts, necessitating decisions that will help define its contours. It also is inevitable that the plaintiffs' bar, Congress and even state legislatures will attempt to devise ways to invalidate class action waivers without running afoul of *Concepcion*.

The plaintiffs' bar, for example, will aggressively advocate for *Concepcion* to be limited to its specific holding and not applied to class action waivers or arbitration agreements generally. Indeed, despite the broad and forceful wording of *Concepcion*, from a technical standpoint it only addressed the extent to which a state-law rule based on a state-law unconscionability doctrine is preempted by the FAA. The plaintiffs' bar will therefore assert multiple other arguments that have historically invalidated arbitration agreements with class action waivers, such as the argument that class action waivers undermine the ability of individuals to vindicate unwaivable statutory rights. *See, e.g., Gentry*, 42 Cal. 4th 443. Though we view *Concepcion* as applying equally to these arguments given its broad language and its heavy emphasis on enforcing the parties' agreement to arbitrate in the interest of promoting efficiency, the Company should nonetheless be aware of the strong likelihood that such arguments will be asserted, as well as the potential that some courts may accept them.

The plaintiffs' bar will also advocate for the imposition of new procedural restrictions on class action waivers that, while not expressly forbidding them, will make them much less practical for employers to utilize and much less likely to be signed by employees. Arguments for such restrictions will be made in light of the *Concepcion* Court's acknowledgment that "states remain free to take steps addressing the concerns that attend contracts of adhesion – for example, requiring class-action-waiver provisions in adhesive arbitration agreements to be highlighted."

We also expect the plaintiffs' bar to attempt to exploit the leanings of Justice Thomas in this area of law in a manner that would substantially restrict the application of the FAA in state court cases. Justice Thomas – regarded by some as the deciding vote in cases involving preemption and/or procedural issues related to the FAA – has expressed the view that Congress intended the FAA to be a procedural statute that may only be applied in federal courts. *See, e.g., Allied-Bruce Terminix Cos. v. Dobson*, 513 U.S. 265 (1995) (Thomas, J., dissenting); *Buckeye Check Cashing, Inc. v. Cardegna*, 546 U.S. 440 (2006) (Thomas, J., dissenting) ("[I]n state-court proceedings, the FAA cannot be the basis for displacing a state law that prohibits enforcement of an arbitration clause contained in a contract that is unenforceable under state law.").[6] Plaintiffs may use this angle as a basis for arguing that – at least in state-court cases – the FAA is inapplicable and therefore cannot preempt state-law unconscionability rules in the context of class action waivers. Though we view such an argument as unlikely to gain much traction, it is nonetheless an argument to consider and keep in mind.

In addition, a potential new avenue for challenging class action waivers stems from the National Labor Relations Act ("NLRA"). Section 7 of the NLRA guarantees all employees, including those who are not represented by a union, the right to engage in "concerted activities." Though the National Labor Relations Board ("NLRB") has not yet issued any decisions regarding the interplay between Section 7 and class action waivers in arbitration agreements, its former general counsel, Ronald Meisberg, released a memorandum regarding this issue in June 2010 – shortly before his resignation – instructing the Board's regional directors regarding how the issue should be addressed. *See* Memorandum from Ronald Meisberg, Gen. Counsel, NLRB, to All Regional Directors, Officers-In-Charge, and Resident Officers, Memorandum GC-10-06 (June 16, 2010), available at http://www.nlrb.gov/publications/general-counsel-memos. In the memorandum, Meisberg articulates four conclusions on this issue, including:

- Filing a class action lawsuit or classwide arbitral claim along with, or on behalf of, other employees is a protected "concerted" activity under the NLRA, and under the NLRA employees may not be threatened, disciplined, or discharged for doing so;

- A "mandatory arbitration agreement" that is so broadly worded that it can be reasonably read by an employee as prohibiting him or her from engaging in concerted activity under Section 7 of the NLRA – by, for example, filing a class action lawsuit – is unlawful under the NLRA;

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[6] Moreover, the California Supreme Court has held that the procedural components of the FAA do not apply in state court. *See Cable Connections Inc. v. DirecTV, Inc.*, 44 Cal. 4th 1334, 1352 (2008) ("the FAA's procedural provisions…are not controlling…."). Perhaps on this basis, just days after the issuance of *Concepcion* the California Legislature introduced AB 1062, which would impose a procedural hurdle to the enforcement of arbitration agreements with class action waivers by making denials of orders to compel arbitration non-appealable in state court – except in cases involving arbitration under collective bargaining agreements. We will continue to monitor AB 1062.

- Employers may nonetheless require individual employees to sign agreements requiring arbitration of their non-NLRA employment claims, including agreements containing class action waivers, without *per se* violating the NLRA, provided that such agreements clarify that the employees may challenge the enforceability the agreements without employer discipline or retaliation. The enforceability of such agreements would be determined under non-NLRA law; and

- Employees who have signed agreements to arbitrate their non-NLRA claims containing class action waivers are still protected by the NLRA, though employers may of course seek to enforce such waivers.

Unfortunately, these guidelines are less than clear and leave much to be decided by the NLRB and the courts, including the significance of the interplay between (1) the general proposition that "protected concerted activity" – including the filing of class actions – is non-arbitrable under the NLRA; and (2) the specific allowance for arbitration agreements with class action waivers pertaining to "non-NLRA" employment claims. Should the NLRB take an aggressive position, this could pose a hurdle to the Company's successful enforcement of an arbitration provision with a class action waiver due to the risk that the waiver – even if limited to the class/collective action context – would constitute an impermissible waiver of the right to engage in concerted activity under the NLRA. In the meantime, should the Company decide to implement such a provision in its employment agreements, there are several clauses specific to this issue that it should consider including that would help protect against this risk.

Another potential avenue for challenging class action waivers could arise in the context of equal employment opportunity claims, including claims under Title VII of the Civil Rights Act of 1964, as amended ("Title VII"), the Age Discrimination in Employment Act of 1967, as amended ("ADEA"), and the Americans with Disabilities Act of 1990, as amended ("ADA"). Both the Supreme Court and the Equal Employment Opportunity Commission ("EEOC") have concluded that individuals may file charges of discrimination with the EEOC under such laws notwithstanding any restrictions on their rights to institute private, classwide litigation in the courts. *See, e.g., Gilmer v. Interstate/Johnson Lane Corp.*, 500 U.S. 20, 28 (1991) (individual ADEA claimant subject to an arbitration agreement is free to file charge with EEOC, even though not able to institute a private judicial action). A broadly-worded arbitration provision with a class action waiver would therefore be unlikely to hold up in the EEO context, at least to the extent that it purports to restrict an employee's right to bring a charge with the EEOC – including, notably, a "pattern and practice" charge asserting systemic discrimination against classes of employees. Thus, while the Company could potentially prevent certain employees from filing EEO class/collective actions in the courts, it

may in any event be required to defend against any class/collective claims brought directly by the EEOC based on or derived from those same employees' charges of discrimination.[7]

Congress may also affect the impact of *Concepcion*. In fact, on the day of the *Concepcion* decision, Senator Al Franken of Minnesota issued a press release criticizing the decision and promising to reintroduce the Arbitration Fairness Act ("AFA"), which had previously been proposed in 2009 and, if passed, would eliminate forced arbitration clauses in employment, consumer, and civil rights cases, and would allow consumers and workers to choose arbitration in the event of a dispute. Franken, along with Senator Richard Blumenthal and Congressman Hank Johnson, has since reintroduced the AFA. While we doubt that the AFA will gain much traction given the current makeup of Congress, its reintroduction serves as a reminder that the issue of the validity of class action waivers is controversial and ongoing.

B. Post-*Concepcion* Strategy

Should the Company decide to implement an arbitration agreement with a class action waiver in light of *Concepcion* – notwithstanding the above-described risks with regard to the enforcement of such a provision – we recommend it do so in relatively conservative fashion, taking into account minimum unconscionability standards and analogizing the agreement as much as possible to the agreement at issue in *Concepcion*. For example, we would recommend that the Company include, at minimum, an opt-out clause providing that employees who do not wish to be bound to binding arbitration or waive their class action rights may opt out of the agreement. At the same time, we would recommend that the Company not view continued employment as consideration for the agreement to arbitrate, as (a) many courts are likely to find continued employment alone to be insufficient consideration; and (b) continued employment as consideration would conflict with any opt-out clause that the Company decides to implement.[8] Implementing an arbitration agreement with a class action waiver in light of issues such as these will help account for – and mitigate – some of the risks outlined above.

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[7] Interestingly, just one day after the issuance of *Concepcion*, the U.S. District Court for the Southern District of New York issued an opinion denying a defendant's motion to compel arbitration in a Title VII pattern and practice case. In *Chen-Oster v. Goldman, Sachs & Co.*, No. 10 CIV 6950 (LBS) (JCF) slip op. at *3 (S.D.N.Y. April 28, 2011), the court, despite acknowledging that the terms of the arbitration agreement at issue would preclude classwide arbitration of the employee's Title VII pattern and practice claims, refused to enforce the agreement. The court hinged its determination in this regard on the notion that "pattern and practice" claims, by their nature, can only be brought as class actions, and that as a result, the enforcement of the parties' arbitration agreement would impermissibly deny the enforcement of plaintiffs' substantive rights. Notably, however, the court in *Chen-Oster* did not reference *Concepcion*, thus suggesting that it may not have been aware of *Concepcion* when rendering its decision. Of course, given the force of the Supreme Court's pronouncements in *Concepcion*, we view *Chen-Oster* as a questionable decision at this point.

[8] In order to establish sufficient consideration for the agreement to arbitrate, the Company might, for example, make the arbitration provision mutual, such that the Company is also required to arbitrate any disputes that are subject to the agreement.

In any event, to the extent the Company would like to move forward with the implementation of an arbitration agreement with a class action waiver, we would be happy to recommend a detailed set of provisions to consider including in any such agreement, as well as a draft arbitration agreement for your review.

CONCLUSION

Concepcion provides the Company with its most promising basis yet for adding an arbitration provision with a class action waiver clause to its employment agreements, and the Company may be able to cut off future class action exposure in light of it. However, due to the multiple ways in which we expect the plaintiffs' bar, the courts, administrative agencies, and Congress to attempt to limit the effect of *Concepcion*, at this point we do not view *Concepcion* as a decision that will in any way guarantee the enforcement of class action waiver provisions. Indeed, the overall impact of *Concepcion* remains to be determined.

Should the Company determine that it would like to implement an arbitration agreement with a class action waiver, we recommend it do so conservatively. In this regard, we would be happy to recommend a set of specific provisions for the Company to consider, draft an arbitration agreement for the Company's review, or otherwise answer any additional questions the Company may have regarding these issues.