Can California Protect Employees from Entering into Mandatory Pre-Dispute Arbitration Agreements and Avoid Federal Preemption?

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In California, legislative efforts to prevent employers from requiring employees to sign pre-dispute arbitration clauses, removing the right to a court or jury trial, have traveled a long and rocky road. The biggest rock — really a boulder — has been the doctrine of federal preemption. Does the Federal Arbitration Act (FAA) preempt California's most recent attempt to prevent employers from requiring employees to enter into mandatory pre-dispute arbitration agreements?

We describe California's legislative efforts and the state of the law. And spoiler: because the state of the law is evolving, and may yet change, we offer our best suggestions for what employers and employees can do under current uncertain circumstances in California.

The FAA (1925), like its predecessor the New York Arbitration Act (1920), was a response to judicial hostility to arbitration, and an effort to create an economic and efficient means to resolve disputes among merchants. Earlier judicial hostility to arbitration meant parties could revoke arbitration agreements and courts could refuse to enforce arbitration agreements that ousted courts of jurisdiction. Section 2 of the FAA intends to overcome that historic judicial hostility, for section 2 provides that a written arbitration agreement "shall be valid, irrevocable, and enforceable, save upon such grounds as exist at law or in equity for the revocation of any contract." (9 USCS § 2.) In practice, section 2 means arbitration agreements are to be enforced as written unless there is an established defense in law or equity for revoking the contract, such as lack of consent, unconscionability, or fraud.

California's efforts to preserve the right of aggrieved employees to go to court have played in three acts. In act 1, our Legislature passed Assembly Bill (AB) 465, banning employers from requiring arbitration as a condition of employment, and making the arbitration agreement unenforceable. Governor Jerry Brown vetoed this bill on the ground that cases consistently held a blanket ban of arbitration violated the FAA. In act 2, the Legislature passed AB 3080, prohibiting an employer from requiring an employee to waive a judicial forum as a condition of employment. This too was vetoed by Brown as a violation of federal law.

And so we come to act 3, AB 51, included in Labor Code section 432.6, and Government Code section 12953, declaring it an unlawful employment practice for an employer to violate section 432.6 of the Labor Code. What distinguishes AB 51 is that it aims at pre-agreement conduct and does not invalidate or render unenforceable a signed arbitration agreement.

Labor Code section 432.6 provides that a person shall not, as a condition of employment, continued employment, or receipt of an employment-related benefit, require an applicant for employment to waive any right, forum, or procedure for a violation of any provision of the Fair Employment and Housing Act (FEHA), including the right to file and pursue a civil action. Also, the employer cannot threaten, retaliate, or discriminate against, or terminate an employee applicant for refusing to consent to waiving any right, forum, or procedure for a violation of FEHA, including the right to file a civil action. Note again that the described conduct is pre-agreement conduct.

Can an employee opt out? No, the Legislature took care of such a loophole, by defining an agreement requiring employees to opt out of a waiver to preserve their rights as "a condition of employment."

Section 432.6 does not apply to a person registered with a self-regulatory organization as defined by the Securities Exchange Act of 1934 (which would cover the Financial Industry Regulatory Authority also known as FINRA), post-dispute settlement agreements, or negotiated severance packages.

Section 432.6 applies to contracts for employment entered into, modified, or extended after January 1, 2020.

Notably, section 432.6 does *not* invalidate a written arbitration agreement otherwise enforceable under the FAA. This final point is important, for it means that a signed arbitration agreement remains enforceable, even though California can now smack the employer for conduct leading to the formation of the agreement.

In *Chamber of Commerce v. Bonta* (9th Cir. 2021) 2021 US App LEXIS 27659, the Ninth Circuit reviewed the grant of a preliminary injunction requested by the U.S. Chamber of Commerce and other industry groups to enjoin California from enforcing section 432.6 as to arbitration agreements covered by the FAA. The district court had concluded that section 432.6, subdivisions (a)-(c) was preempted by the FAA. The Ninth Circuit reversed in part, holding that AB 51 was not preempted, except as to certain civil and criminal penalties that did burden arbitration agreements. Judge Carlos F. Lucero of the 10th Circuit, sitting by designation, wrote for the majority, joined by Judge William A. Fletcher, and Judge Sandra S. Ikuta dissented. As Judges Lucero and Fletcher were Clinton appointees, and Judge Ikuta was a Trump appointee, the judges' legal and philosophical division concerning arbitration lined up with their party affiliations.

The majority opinion makes several points. First, an arbitration agreement must be voluntary and consensual, and since the state legislation seeks to promote voluntariness and consent, it is not at

odds with the FAA. Second, the imposition of civil and criminal sanctions for executing an arbitration agreement does conflict with the FAA, and therefore such sanctions are preempted. Third, the California law does not create a contract defense that allows a signed arbitration agreement to be invalidated. Fourth, on its face, the law does not discriminate against arbitration, because where it mentions arbitration, it says arbitration agreements may be enforced. Fifth, unlike cases that, based on federal preemption, refuse to allow state laws to invalidate arbitration agreements, here, AB 51 aims at "conduct that takes place prior to the existence of any such agreement." As we shall see, where the majority focuses on preemption and the invalidity of laws that *invalidate a signed arbitration agreement*, and the majority claims AB 51 is solely directed at pre-agreement conduct, the dissent focuses on the preemption of state laws that impact *formation* of an arbitration agreement.

Judge Ikuta wrote a blistering dissent. She began by stating: "Like a classic clown bop bag, no matter how many times California is smacked down for violating the Federal Arbitration Act, the state bounces back with even more creative methods to sidestep" it. She termed the bill as a "gimmick" and "a blatant attack on arbitration agreements" that was consistent with the anti-arbitration laws passed by the Legislature in earlier sessions and either vetoed by Governor Brown or struck down by the Court of Appeal. She disagreed with the majority's premise that *Kindred Nursing Centers Limited Partnership v. Clark* (2017) 137 S. Ct. 1421 and similar cases cited by plaintiffs, were distinguishable because they applied to executed contracts rather than contract formation.

She observed that in *Kindred,* the parties opposing arbitration advanced an argument based on the distinction between contract formation and contract enforcement and the Supreme Court rejected this distinction.

Indeed, when Governor Brown vetoed AB 3080, a bill that was very similar to AB 51, he cited Justice Kagan's statement in *Kindred* that "a rule selectively finding arbitration contracts invalid because improperly formed fares no better under the Act than a rule selectively refusing to enforce these agreements once properly made."

Given that the Ninth Circuit dissolved the injunction issued by the district court, employers who previously required employees to enter into arbitration agreements as a condition of employment now have to consider whether they should comply with the statute when they enter into arbitration agreements with new employees.

Employers might choose to ignore the statute, though they do so at their own risk. First, the plaintiffs have filed a petition for a rehearing en banc and so employers may decide that the Ninth Circuit's ruling is likely to be overturned by the en banc panel or by the Supreme Court. Second, and more interestingly, the statute may be ineffectual.

Judge Ikuta raised the issue of the statute's ineffectiveness in her dissent when she criticized the majority's reasoning for holding that the statute's criminal penalties were preempted. In so holding, the majority stated: "An arbitration agreement cannot simultaneously be 'valid' under federal law and grounds for a criminal conviction under state law." The "valid" contract to which the majority referred had to be a contract imposed as a condition of employment because that was the only type of contract that gave rise to the criminal penalties. In other words, an employer violates the statute by requiring execution of an arbitration agreement to be a condition of employment, but the ensuing executed agreement is nevertheless valid and enforceable. Judge Ikuta likened this situation to a statute where a drug dealer is criminally liable for offering to sell drugs but the sale itself is lawful.

But the majority should not be criticized for this bizarre result. It was hamstrung by the FAA.

If an employee files suit in court and opposes the employer's motion to compel arbitration because the arbitration agreement was in violation of AB 51, the employee's argument would be that the agreement was signed involuntarily because it was a condition of employment. The employee could not raise that defense in the case of, say, a dispute involving a covenant not to compete or a confidentiality agreement. The FAA requires that arbitration contracts be on equal footing with other contracts and a state law that provides a defense against arbitration agreements but not other contracts is preempted by the FAA. (*Southland Corp. v. Keating* (1984) 465 U.S. 1, 10; *DirecTV v. Imburgia* (2015) 577 U.S. 47, 58-59.) Thus, the majority's only choice was to concede that an arbitration agreement offered as a condition of employment, once signed, is valid.

An employer who chooses to ignore the statute should be careful, however. If the FAA does not apply, the preemption argument will not be available and an executed contract presented as a condition of employment will not be valid. Contracts not covered by the FAA not only include contracts in intrastate commerce, but also include contracts which specifically state that the California Arbitration Act will apply as well as contracts with transportation workers because section 1 of the FAA exempts transportation workers from its coverage. (See *Garrido v. Air Liquide Industrial US LP* (2015) 241 Cal. App. 4th 836, 839-841; *Rittman v. Amazon.com, Inc.* (9th Cir. 2020) 971 F.3d 904, 916-919.) In addition, criminal liability is only avoided if the employee signs the agreement. If an employer demands that an employee sign the agreement as a condition of employment and the employee refuses to sign, then the employer remains criminally liable.

On the other hand, there may be good reason to comply with the statute, notwithstanding a belief that it does not affect contracts covered by the FAA. An employee who signs a contract that is a condition of employment and later has a dispute with the employer is likely to file suit in federal or state court and the employer will have to expend legal fees filing a motion to compel arbitration and defending against the employee's challenge to it. If the contract is not a condition of employment, most employees will probably still sign it and, if a dispute arises, will be more likely to initiate resolution of the dispute in an arbitral forum. Of course, this may not be a "one size fits all" solution for employers. For example, some employers may so fear the risk of class actions that they will always want to compel arbitration and pay the cost of doing so, putting them in a position to "divide and conquer" with individual arbitrations.

In a bit of irony, it can be argued that the statute is helpful to the arbitration process. Many legislators, academics, attorneys, and members of the media have a negative view of arbitration. This largely stems from the fact that most employment and consumer arbitration agreements are imposed as a condition of employment or purchase of a product. If the general practice changes and entrance into an arbitration agreement becomes optional for the employee or consumer, many objections to arbitration, often manifested in legislation and unflattering articles, might disappear.

Finally, what can an employee do to assert his or her rights under the statute? If the FAA applies, there probably is little that can be done if the employer makes execution of the contract a condition of employment, but the employee has nothing to lose by at least raising the existence of the statute. If the employer persists then the employee will need to sign the contract unless the employee is willing to look elsewhere for a position. True, if the statute is valid the employer may be subject to penalties for conduct before the agreement is signed. Yet even if the statute is valid, so too will be the signed arbitration agreement, assuming the agreement doesn't have other problems for the employer and employee to fight over.