Legal Backgrounder

Vol. 32 No. 14 June 16, 2017

Washington Legal Foundation
Advocate for Freedom and Justice®
2009 Massachusetts Avenue, NW
Washington, DC 20036
202.588.0302 wlf.org

Courts in California Enable End-Run of Federal Arbitration Act by Expanding Obscure State Labor Law

by John F. Querio

California courts have long been hostile to enforcing arbitration agreements in employment and consumer protection cases, especially when arbitral class-action waivers are at issue. The US Supreme Court's decision in *AT&T Mobility LLC v. Concepcion*, 563 U.S. 333 (2011), should have put this regrettable tendency to rest. However, in the years since *Concepcion*, the plaintiffs' bar and California courts have transformed a hitherto little-used state statute, the Labor Code Private Attorneys General Act of 2004 (PAGA), into a vehicle for circumventing the mandate of the Federal Arbitration Act (FAA) that arbitral limits on collective litigation must be respected. While courts in California have so far held that PAGA prohibits enforcement of class- and representative-action waivers in arbitration agreements and that the FAA does not preempt this result, the US Supreme Court has not yet weighed in on this issue. It may soon get the chance to do so.

California Courts' Historical Hostility to the FAA

The FAA "mandates enforcement of agreements to arbitrate statutory claims." *Shearson/Am. Express, Inc. v. McMahon*, 482 U.S. 220, 226 (1987). Three decades ago, however, the US Supreme Court in dictum suggested that arbitration agreements might be invalidated where they operated "as a prospective waiver of a party's right to pursue statutory remedies." *Mitsubishi Motors Corp. v. Soler Chrysler-Plymouth, Inc.*, 473 U.S. 614, 637 n.19 (1985).

This dictum became known as the "'effective vindication' exception" to the FAA. *American Express Co. v. Italian Colors Restaurant*, 133 S. Ct. 2304, 2310 (2013). This exception was derived not from the language of the FAA, but instead from the possibility that another federal statute might evince Congress's intent to exempt certain federal statutory rights from arbitration. *Mitsubishi Motors*, 473 U.S. at 627-28. Since the FAA's mandate "may be overridden by a contrary congressional command," the Court signaled this command could be deduced "from an inherent conflict between arbitration" and a federal statute. *McMahon*, 482 U.S. at 226-27.

The US Supreme Court has never actually applied this effective-vindication dictum to invalidate an arbitration agreement. *Italian Colors*, 133 S. Ct. at 2310. Nor has it suggested this dictum could justify the invalidation of an agreement to arbitrate state-law claims. Nonetheless, before *Concepcion*, the California Supreme Court warped the vindication defense into a basis for refusing to enforce agreements to arbitrate state statutory claims in the consumer-protection and employment/wage-and-hour contexts, on the ground that this was necessary to prevent "the vitiation through arbitration of the substantive rights afforded by" state law.[1]

[1] *See Broughton v. Cigna Healthplans of California*, 21 Cal. 4th 1066, 1083 (1999); *see also Armendariz v. Foundation Health Psychcare Services, Inc.*, 24 Cal. 4th 83, 90-91, 98-103 (2000); *Little v. Auto Stiegler, Inc.*, 29 Cal. 4th 1064, 1076-81 (2003); *Discover Bank v. Superior Court*, 36 Cal. 4th 148, 160-173 (2005); *Gentry v. Superior Court*, 42 Cal. 4th 443, 456-63, 465 (2007).

John F. Querio is a Partner with Horvitz & Levy LLP in Burbank, CA.

The court insisted that this state-law vindication rationale was not preempted by the FAA because it was based on California's generally applicable policy against exculpatory contracts and therefore fell within the FAA's saving clause, which preserves from preemption "such grounds as exist at law or in equity for the revocation of any contract." 9 U.S.C. § 2 (2016).[2]

The Supreme Court Reinforces the FAA's Mandate in *Concepcion* and *Italian Colors*, but California Courts Continue to Flout It

In *Concepcion*, the US Supreme Court held that the FAA preempted the unconscionability standard the California Supreme Court had invented in *Discover Bank* to invalidate class-action waivers in consumer-arbitration agreements. *Concepcion*, 563 U.S. at 339-40, 352. The California Supreme Court had held that such waivers contravened public policy and were therefore unconscionable because "class actions and arbitrations" are "often inextricably linked to the vindication" of state law, and that the FAA did not preempt this defense because representative-action waivers "may operate effectively as exculpatory contract clauses" in violation of California's public policy. *Discover Bank*, 36 Cal. 4th at 155, 160-66, 174.

Concepcion rejected this position, holding that where courts deem arbitration provisions to be "unconscionable or unenforceable" based on "public policy disapproval of exculpatory agreements," such state-law contract defenses "[i]n practice … have a disproportionate impact on arbitration agreements" even though they "presumably apply" to all contracts. *Concepcion*, 563 U.S. at 341-42. *Concepcion* therefore held that state public-policy defenses invalidating arbitration procedures (like representative-action waivers) based on concerns for the vindication of state law are preempted by the FAA. *Id.* at 341-44.

The Supreme Court reaffirmed this holding in *Italian Colors*, concluding that *Concepcion* "all but resolves this case" and expressly rejecting Justice Kagan's dissenting view that *Concepcion* did not involve the vindication rationale. *Italian Colors*, 133 S. Ct. at 2310-13 & n.5. Even Justice Kagan acknowledged that the FAA has "no earthly interest (quite the contrary) in vindicating [state] law. Our effective-vindication rule comes into play only when the FAA is alleged to conflict with another *federal* law." *Id.* at 2320 (Kagan, J., dissenting).

In the wake of *Concepcion* and *Italian Colors*, California courts have persisted in resisting those cases' authoritative interpretation of the FAA and have continued to apply the effective-vindication dictum to invalidate arbitration agreements that contravene state public policy.[3]

California Courts and the Ninth Circuit Incorrectly Shield PAGA Representative Actions from the FAA's Preemptive Scope

California courts' most concerted effort to skirt the FAA's preemptive mandate after *Concepcion* and *Italian Colors*, however, involves PAGA. The California legislature enacted PAGA to permit an employee to bring a representative action "'on behalf of himself or herself and other current or former employees' to recover civil penalties" for wage-related violations of California's Labor Code—penalties that were previously recoverable solely by the state's labor law enforcement agencies. *Amalgamated Transit Union, Local 1756 v.*

[2] *See, e.g.*, *Little*, 29 Cal. 4th at 1076-77, 1079-80; *Discover Bank*, 36 Cal. 4th at 160-67; *Gentry*, 42 Cal. 4th at 456-65 & n.8.

[3] *See, e.g.*, *Sonic-Calabasas A, Inc. v. Moreno*, 57 Cal. 4th 1109 (2013) (holding that courts assessing enforceability of arbitration agreement in wage-and-hour context may consider whether arbitration procedures fail to include certain state-law protections, thereby failing to "provide an employee with an accessible and affordable arbitral forum for resolving wage disputes," and that the FAA does not preempt this rule where such procedures help vindicate state statutory rights); *Sanchez v. Valencia Holding Co.*, 61 Cal. 4th 899 (2015) (reaffirming that arbitration provisions may be unenforceable if they contravene state public policy and that this rule is not preempted by the FAA); *McGill v. Citibank, N.A.*, 2 Cal. 5th 945 (2017) (holding that arbitral class-action waiver was unenforceable as against California public policy where it prevented plaintiff from seeking injunctive relief on behalf of others under state statutes, and that this rule was not preempted by the FAA under effective-vindication rationale).

© 2017 Washington Legal Foundation

Superior Court, 46 Cal. 4th 993, 1003 (2009). PAGA "does not create property rights or any other substantive rights. Nor does it impose any legal obligations. It is simply a procedural statute ... ." *Ibid.*

In *Iskanian v. CLS Transportation Los Angeles, LLC*, 59 Cal. 4th 348 (2014), the California Supreme Court addressed the enforceability of a provision in an arbitration agreement that waived an employee's right to bring a representative action under PAGA. The court held that a PAGA representative action is "a type of qui tam action" resembling a private suit brought under the federal False Claims Act (FCA), in that the named plaintiff is a proxy for the state. *Id.* at 380-82. *Iskanian* held that an arbitration agreement's PAGA representative-action waiver is unenforceable as a matter of "public policy" because (like the class-action waiver in *Discover Bank*) it violated California's policy against exculpatory contracts by frustrating the enforcement of state statutes. *Id.* at 382-84. *Iskanian* further concluded that the FAA did not preempt this rule because the rule's "sole purpose is to vindicate" the enforcement of this state law rather than to interfere with arbitration. *Id.* at 384-89.

The Ninth Circuit agreed that the FAA did not preempt the *Iskanian* rule in *Sakkab v. Luxottica Retail North America, Inc.*, 803 F.3d 425 (9th Cir. 2015). Following an analysis virtually identical to that employed by the pre-*Concepcion* cases that produced the preempted *Discover Bank* rule, *Sakkab* held that: (1) *Iskanian*'s rule is predicated on California's policy against exculpatory contracts since PAGA representative-action waivers frustrate the enforcement of state statutes; (2) the rule is therefore a generally applicable contract defense that is preserved from FAA preemption; and (3) the rule does not conflict with the FAA since the "'sole purpose'" of the underlying state policy "'is to vindicate'" the enforcement of state statutes via a *qui tam* representative action. *See id.* at 430-33, 439-40.

The *Sakkab* majority claimed that it was not relying on the vindication rationale to save the *Iskanian* rule from FAA preemption, stating that the vindication rationale applies only to federal laws. *See Sakkab*, 803 F.3d at 433 n.9. But this claim was belied by *Sakkab*'s determination that the FAA did not preempt the *Iskanian* rule because it is based on a state public policy against exculpation that seeks to vindicate the enforcement of state law. *See id.* at 430-31, 439-40; *see also id.* at 448-49 (Smith, N. R., J., dissenting) (explaining that California's policy concerns cannot save *Iskanian* from preemption, and that the majority's contrary conclusion "strays" toward inapplicable vindication defense).

While the Ninth Circuit in *Sakkab* apparently saw a profound distinction between the vindication of state law by an individual and the vindication of the same law by a proxy of the state, *see id.* at 435-36, 439-40, this is a distinction without a difference under the FAA. That California law seeks to shield PAGA representative actions in an effort to vindicate California's enforcement of state wage-and-hour statutes does not change the fact that California's policy concerns cannot override the FAA's mandate requiring arbitration agreements—including provisions that waive procedures allowing representative proceedings—to be enforced according to their terms. *See Concepcion*, 563 U.S. at 341-44.

The *Iskanian*/*Sakkab* Rule Singles Out Arbitration Agreements Containing PAGA Representative-Action Waivers for Disfavored Treatment

While the FAA "preempts any state rule discriminating on its face against arbitration," it "also displaces any rule that covertly accomplishes the same objective by disfavoring contracts that (oh so coincidentally) have the defining features of arbitration agreements." *Kindred Nursing Ctrs. Ltd. P'ship v. Clark*, __ U.S. __, No. 16-32, 2017 WL 2039160, at *4 (May 15, 2017); *see also DIRECTV, Inc. v. Imburgia*, 136 S. Ct. 463, 468 (2015) (FAA requires "plac[ing] arbitration contracts 'on equal footing with all other contracts'"). The *Iskanian*/*Sakkab* rule falls afoul of this principle because it treats PAGA representative actions differently depending on whether an arbitration agreement containing a representative-action waiver is at issue, in a manner that disfavors arbitration.

ISBN 1056 3059

Central to the *Iskanian*/*Sakkab* rule is the premise that a PAGA representative action "'is fundamentally a law enforcement action designed to protect the public and not to benefit private parties.'" *Iskanian*, 59 Cal. 4th at 381; *see also id.* at 382 ("The government entity on whose behalf the plaintiff files suit is always the real party in interest in the suit."). Under *Iskanian* and *Sakkab*, "a PAGA claim lies outside the FAA's coverage because it is not a dispute between an employer and an employee arising out of their contractual relationship. It is a dispute between an employer and the *state,* which alleges directly or through its agents ... that the employer has violated the Labor Code." *Id.* at 386-87; *see also Sakkab*, 803 F.3d at 435-36 (same).

However, in other contexts, courts have treated PAGA representative actions as private civil actions between employees and their employer, rather than law-enforcement actions between the employer and the state. The Ninth Circuit recently confronted this question in deciding whether a PAGA representative action was subject to the automatic stay of 11 U.S.C. § 362 after the employer declared bankruptcy. *See Porter v. Nabors Drilling USA, L.P.*, 854 F.3d 1057 (9th Cir. 2017). The Bankruptcy Code contains an exception to the automatic stay that applies to "actions 'by a governmental unit ... to enforce such governmental unit's ... police and regulatory power.'" *Id.* at 1061. In rejecting the plaintiff's argument that his PAGA representative action qualified for this exception, the Ninth Circuit explained that it was "not persuaded that the government's creation of a private right of action to enforce laws aimed to protect the health and safety of the public is sufficient governmental involvement to invoke the exception to the bankruptcy stay." *Id.* at 1062.

Thus, courts in California change their treatment of representative PAGA actions—as lawsuits between the state and an employer or as lawsuits between employees and their employer—depending on whether an arbitration agreement with a representative-action waiver is at issue, in order to disfavor arbitration. The US Supreme Court has condemned this type of discriminatory treatment when it is used to undermine arbitration.[4]

Conclusion

So far, the PAGA phenomenon and courts' resistance to FAA preemption of the *Iskanian*/*Sakkab* rule have been confined to California. However, PAGA could become a model that other states follow, if the US Supreme Court does not intervene. It could be very attractive for states with stretched budgets and depleted treasuries to create new *qui tam* causes of action through which employees can enforce wage-and-hour laws by seeking to recover from their employers civil penalties that are largely payable to the state's coffers. If other states enact PAGA-like statutes and follow the reasoning of the *Iskanian*/*Sakkab* rule, this could blow a gaping hole in the solid bulwark that the FAA has provided against collective litigation since *Concepcion*.

The US Supreme Court currently has pending before it a petition for writ of certiorari presenting the question whether the *Iskanian*/*Sakkab* rule falls afoul of the FAA. *See Vitolo v. Bloomingdale's, Inc.*, 669 F. App'x 890 (9th Cir. 2016), *pet. for cert. filed*, 85 U.S.L.W. 3468 (U.S. Mar. 15, 2017) (No. 16-1110). Whether the Court grants review in *Vitolo* or another case presenting the same question will go a long way toward determining the future course of FAA preemption jurisprudence. Stay tuned.

[4] *See Kindred Nursing Ctrs.*, 2017 WL 2039160, at *5 n.1 (pointing to the fact that state court's treatment of arbitration agreements "appears not to apply to other kinds of agreements" as evidence that its rule "arises from the suspect status of arbitration" and thus is preempted under the FAA); *Imburgia*, 136 S. Ct. at 470 (holding state court's interpretation of arbitration agreement preempted under the FAA where it "appears to reflect the subject matter at issue here (arbitration), rather than a general principle that would apply to contracts using similar language but involving state statutes invalidated by other federal law").

© 2017 Washington Legal Foundation ISBN 1056 3059