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Ninth Circuit largely upholds controversial California law targeting employer-mandated arbitration agreements

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On September 15, 2021, in a decision with potential ramifications for California employers, the Ninth Circuit partially upheld a 2019 California law, known as Assembly Bill 51 ("AB51"), that bars employers from requiring employees to sign broad arbitration agreements as a condition of employment.[1]

In recent years, the California Legislature has made multiple attempts to legislatively ban mandatory employee arbitration agreements in response to criticisms by some workers' rights advocates that arbitration agreements make it more difficult for employees to challenge alleged unlawful employment practices.

AB51 bars employers from requiring employees to sign agreements to arbitrate claims under the California Labor Code or the California Fair Employment and Housing Act as a condition of employment.

In 2015 and 2018, former Governor Jerry Brown vetoed two such bills, arguing that they were inconsistent with the Federal Arbitration Act ("FAA"), a federal statute that, among other things, preempts state laws that specially disfavor arbitration agreements.

In 2019, with Governor Brown out of office, the Legislature passed (and current Governor Gavin Newsom signed) AB51.

Like its predecessors, AB51 bars employers from requiring employees to sign agreements to arbitrate claims under the California Labor Code or the California Fair Employment and Housing Act as a condition of employment, and also prohibits employers from taking adverse action against any employee who refuses to sign such an agreement.[2]

AB51 also creates civil and criminal penalties for any employer that violates these prohibitions.[3] However, in an apparent bid to avoid FAA preemption, AB51 provides that any arbitration agreement an employee signs, despite an employer having violated AB51, is nevertheless enforceable.[4]

Prior to AB51's effective date, a group of business organizations led by the U.S. Chamber of Commerce filed suit in the Eastern District of California seeking a declaration that AB51 is preempted by the FAA. The district court agreed with the plaintiffs that AB51 unlawfully discriminates against arbitration agreements and enjoined its enforcement, prompting state officials to appeal to the Ninth Circuit.

In a 2-1 decision, the Ninth Circuit reversed in part. The panel majority first rejected the plaintiffs' argument that AB51 directly conflicts with Section 2 of the FAA, which provides in relevant part that "a contract evidencing a transaction involving commerce to settle by arbitration a controversy thereafter arising out of such contract or transaction ... shall be valid, irrevocable, and enforceable, save upon such grounds as exist at law or in equity for the revocation of any contract."[5]

The court held that AB51 does not implicate Section 2, because it targets only an employer's pre-contract conduct, and does not create any mechanism to void an arbitration agreement.

The court next rejected the plaintiffs' argument that AB51 conflicts with the FAA's purpose because it creates a significant obstacle to an employer entering into an arbitration agreement with an employee. The court held that the FAA's purpose is to remove obstacles to enforcing freely negotiated arbitration agreements, and because AB51 targets involuntary arbitration agreements "forced upon" employees, it does not conflict with the FAA.

Finally, however, the court held that AB51's civil and criminal penalties impermissibly chill employers from seeking to enforce otherwise-valid arbitration agreements, and therefore affirmed the district court's decision enjoining these provisions to the extent they apply to executed arbitration agreements.

In other words, the court held that while employers can be civilly and criminally liable if they seek to require an employee to sign a mandatory arbitration agreement and the employee refuses, they cannot be civilly and criminally liable if the employee actually signs the agreement.

The Ninth Circuit's decision leaves considerable uncertainty in its wake. The first, and most salient, question is whether the decision will ultimately stand. The plaintiffs seem likely to appeal to the Supreme Court, and there is a higher-than-usual probability that the Court will take the case in light of: (i) the significant attention it has granted to FAA cases in recent years; and (ii) the Circuit split the Ninth Circuit's decision arguably creates with cases decided by the First and Fourth Circuits in 1989 and 1990.

If the Court takes the case, it may well reverse the Ninth Circuit. As Judge Ikuta persuasively argued in her dissent, the majority's decision is in tension with the Supreme Court's 2017 decision in *Kindred Nursing Centers Limited Partnership v. Clark*, 137 S. Ct. 1421 (2017), which held that the FAA preempted a Kentucky common law rule providing that a person holding a power of attorney for a family member could not bind the family member to an arbitration agreement unless the instrument granting the power of attorney expressly included the right to enter into arbitration agreements.

The court held that while employers can be civilly and criminally liable if they seek to require an employee to sign a mandatory arbitration agreement and the employee refuses, they cannot be civilly and criminally liable if the employee actually signs the agreement.

In that case, the Court rejected an argument that the FAA does not preempt rules governing pre-contractual conduct like the Kentucky rule at issue, observing that the FAA "cares not only about the enforcement of arbitration agreements, but also about their initial validity — that is, about what it takes to enter into them."[6]

While the panel majority dismissed this conclusion as dictum, the current Court, which has issued a number of pro-arbitration decisions in the last decade, may well reject the more restrictive view of FAA preemption advanced by the Ninth Circuit.

The Ninth Circuit's decision may also be in tension with the FAA's purpose of preempting legal rules that disfavor arbitration or treat arbitration agreements differently from other contracts. The panel majority argued that AB51 does not conflict with the FAA's purpose because the FAA reaches only consensual arbitration agreements, while AB51 targets involuntary arbitration agreements.

However, contracts that one party signs without negotiation because the other party has greater bargaining power are nonetheless ordinarily enforceable unless the contract is "substantively unconscionable" — meaning that it is oppressively unfair or one-sided.

By making it unlawful for employers to use their bargaining power to require arbitration agreements that are not substantively unconscionable, AB51 arguably requires greater consent for arbitration agreements than California law generally requires for other types of contracts. This potentially violates the FAA's nondiscrimination principle.

If the Ninth Circuit's decision ultimately stands, it may raise questions for employers about whether to ask employees to sign arbitration agreements or forego such agreements and potentially open the door for employees to leverage the often-sizable discovery costs associated with California state court litigation to extract monetary settlements from employers for weak or unsubstantiated employment claims.

Because of the issues raised, employers are sure to follow the future of this litigation closely. However, even if the Ninth Circuit's decision is ultimately overturned, employers should be aware that AB51 may not disappear entirely.

The FAA reaches contracts that involve interstate commerce.

While the Supreme Court in *Allied-Bruce Terminix Companies v. Dobson*, 513 U.S. 265 (1995), held that the FAA reaches every contract that Congress can regulate under the Constitution's Commerce Clause, that excludes contracts that have no connection to interstate commerce.

Thus, AB51 may continue to apply to employers with purely intra-state operations even if its broader application is preempted by the FAA.

Notes

[1] *Chamber of Commerce of U.S.A. v. Bonta*, No. 20-15291, 2021 WL 4187860 (9th Cir. Sept. 15, 2021).

[2] *See* Cal. Lab. Code § 432.6(a)-(b).

[3] *See* Cal. Lab. Code §§ 23, 433; Cal. Gov't Code §§ 12953, 12960-65.

[4] *See* Cal. Lab. Code § 432.6(f).

[5] 9 U.S.C. § 2.

[6] *Id.* at 1428 (brackets and internal quotation marks omitted).

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