Class actions dodge another bullet from industry gunslingers (but how long can this last?)

A look at what impact Gentry *and* Discover Bank *may have on California class actions*

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California wage and hour class actions recently dodged another bullet aimed by industry at eliminating such class actions. However, the bullet just barely missed. On August 30, 2007, in a close 4 to 3 decision, the California Supreme Court held in *Gentry v. Superior Court*, 42 Cal.4th 443, that – "in at least some cases" – class-wide arbitration waivers in employment contracts are unenforceable. The *Gentry* decision follows close on the heels of the Supreme Court's 2005 decision in *Discover Bank v. Superior Court*, 36 Cal.4th 148, in which the Court similarly held by the same narrow margin that class action arbitration waivers in consumer contracts are unenforceable "under some circumstances."

Although the *Gentry* decision and earlier *Discover Bank* decision represent victories for opponents of class action arbitration waivers, given the bare majority in each opinion, a significant risk exists that these victories may be short-lived. A minor change in the future in the composition of the Supreme Court – perhaps with the appointment of a more "pro-business" jurist to the Court – could lead to a reversal of these decisions that would have extreme consequences for consumer and employment class actions in this state. In short, far from reassuring supporters of class actions, these decisions are alarming examples of just how close class actions have come to being eliminated in California and of just how vulnerable they are to elimination in the future.

Using arbitration clauses to eliminate class actions

We have all seen it before. Companies that hide one-sided contract provisions in the fine print, or impose pro-industry choice of law or venue clauses on unsuspecting customers or employees in take-it-or-leave-it agreements. Corporate America routinely inserts complex legalese in adhesion contracts that attempts to limit customer or employee remedies against the company, relieve the company of liability for punitive damages, shorten the statute of limitations for claims that can be brought against the company or waive the customer or employee's right to a jury trial, to name just a few examples of typical exculpatory clauses included in many company contracts. (*See, e.g., Grafton Partners L.P. v. Superior Court* (2005) 36 Cal.4th 944 (invalidating predispute contractual waiver of right to jury trial).)

In one notorious example, America Online has for years included a choice of law clause in its contracts that specifies Virginia law as controlling in all customer disputes. This results in a windfall for AOL since class actions do not exist under Virginia law. Consequently, millions of AOL customers with small claims have been effectively shut out of courts across the country. Fortunately, in California, courts have refused to enforce AOL's choice of law clause to prevent class actions from being filed against the company. (*See America Online, Inc. v. Superior Court* (2001) 90 Cal.App.4th 1.) But customers in many other states have not been quite as lucky.

Yet the most common and long-standing exculpatory clause by far in corporate America's arsenal of contractual weapons is the mandatory arbitration clause. Starting decades ago, companies began including these arbitration clauses in all types of consumer and employee contracts. Over the years California courts have by and large tended to enforce such arbitration clauses as long as the clauses were not unconscionable. (*See, e.g., Madden v. Kaiser Foundation Hospitals* (1976) 17 Cal.3d 699 (enforcing arbitration clause in health care contract.) Indeed, as a consequence of the passage of the Federal Arbitration Act (9 U.S.C. § 1 et seq.), and the California Arbitration Act (Civ. Proc. Code § 1280 et seq.), contractual arbitration is favored under both state and federal law.

With the resulting proliferation in arbitrations, it should come as no surprise that companies have sought to exploit contractual arbitration to blunt the

effectiveness of class actions. In 1982, in *Keating v. Superior Court*, 31 Cal.3d 584, overruled on other grounds in *Southland Corp. v. Keating* (1984) 465 U.S. 1, the California Supreme Court endorsed the concept of conducting arbitrations of class actions – at least with respect to a class's damage claims – where an enforceable arbitration clause applies to an entire class. Since *Keating*, the damage claims of countless class members have been decided in arbitration rather than superior court.

But companies have not been content to stop there. Once they succeeded in forcing many class actions into arbitration, companies went a step further and came up with new arbitration clauses that both compelled arbitration for individual customers or employees *and* simultaneously waived class-wide arbitration for thousands or millions of class members with identical claims. Under these new arbitration clauses, not only are class actions barred from court, but they cannot even be decided by an arbitration panel.

The *Gentry* and *Discover Bank* decisions

It is against this backdrop that the Supreme Court issued its opinion in *Gentry* on August 30. In *Gentry*, an employee of Circuit City filed a class action in superior court seeking overtime pay for himself and other salaried employees that were allegedly misclassified as managers or executives exempt from the right to receive overtime pay under California statutory employment law. However, Circuit City's binding employment rules and procedures included not only a mandatory arbitration agreement but also a provision purporting to waive any arbitration of class action claims. The employee had 30 days from the commencement of employment to opt out of the arbitration agreement and class arbitration waiver but failed to do so.

The principal issues confronted by the Supreme Court in *Gentry* were whether Circuit City's class-action arbitration waiver was enforceable and whether the employee's right to opt out within 30 days prevented the arbitration agreement and class waiver from being determined to be procedurally unconscionable. Justice Moreno, writing for the Court's majority consisting of himself, Chief Justice George and Justices Kennard and Werdegar, concluded that such class- action arbitration waivers should not be enforced if a trial court, after weighing various factors discussed below similar to those relevant to deciding whether to certify a class action, determines that "class arbitration would be a significantly more effective way of vindicating the rights of affected employees than individual arbitration." (*Gentry*, *supra,* 42 Cal.4th at 450.) The majority furthermore held that Circuit City's arbitration agreement had "an element of procedural unconscionability notwithstanding the opt-out provision." (*Id.* at 451.) Accordingly, the majority remanded the case to the Court of Appeal for further determinations as to whether the class action arbitration waiver should be enforced and whether the entire arbitration agreement was otherwise substantively unconscionable.

The majority in *Gentry* reached these conclusions relying heavily on the Court's prior opinion in *Discover Bank*, which was decided by the same majority consisting of Chief Justice George and Justices Moreno (again writing for the majority), Kennard and Werdegar. As explained by the *Gentry* majority, *Discover Bank* invalidated a class action arbitration waiver that was sent as part of a notice to credit card customers in the form of a "bill stuffer" included in monthly billing statements. Cardholders were deemed to accept the arbitration agreement and class action waiver set forth in the notice if they did not thereafter close their accounts. The majority in *Discover Bank,* as noted by the same majority in *Gentry,* held that "an element of procedural unconscionability" was present as a result of the bill stuffer notice. *(Gentry*, *supra,* 42 Cal.4th at 453, (quoting *Discover Bank*, 36 Cal.4th at 160). The *Discover Bank* majority additionally held that such class action waivers "may also be substantively unconscionable inasmuch as they may operate effectively as exculpatory contract clauses that are contrary to public policy." (*Discover, supra,* 36 Cal.4th at 161.) The *Discover Bank* majority reasoned that because damages in class actions are "often small and because '"[a] company which wrongfully exacts a dollar from each of millions of customers will reap a handsome profit"' [citation omitted], '"the class action is often the only effective way to halt and redress such exploitation."' (*Ibid.*) (citation omitted.) Substantive unconscionability was also found because, according to the majority, "such class action or arbitration waivers are indisputably one-sided." (*Ibid.*)

The majority in *Discover Bank* clarified that not "all class action waivers are necessarily unconscionable." (*Id.* at 162) "But when," according to the *Discover Bank* majority, "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, at least to the extent the obligation at issue is governed by California law, 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.' [citation omitted]" (*Id.* at 162-163.) Consequently, "[u]nder these circumstances, such waivers are unconscionable under California law and should not be enforced." (*Id.* at 163.)

Relying on its prior holding in *Discover Bank*, the majority in *Gentry* analyzed whether a class action or class arbitration waiver in an employment context would be improperly exculpatory, and therefore unenforceable, by undermining enforcement of the important public policy reasons underlying the employee's statutory rights to receive overtime compensation. The *Gentry* majority observed that such statutory rights to receive overtime are *unwaivable*. (*Gentry, supra,* 42 Cal.4th at 456.) Hence, "'arbitration cannot be misused to accomplish a de facto waiver of these rights.'" (*Id*. at 457 (quoting *Little v. Auto Stiegler, Inc*. (2003) 29 Cal.4th 1064, 1079).)

As it did in *Discover Bank* in the context of consumer class actions, the majority in *Gentry* declined to adopt a categorical rule that all class arbitration waivers in overtime cases are unenforceable. (*Id.* at 462.) Instead, the majority adopted a multi-factor test that a trial court must follow in deciding whether such a waiver is enforceable. These factors include:

- the modest size of the potential individual recovery,
- the potential for retaliation against members of the class,
- the fact that absent members of the class may be ill informed about their rights,
- and other real world obstacles to the vindication of class members' right to overtime pay through individual arbitration.

(*Id.* at 463.)

> If [a trial court] concludes," held the *Gentry* majority, "based on these factors, that a class arbitration is likely to be a significantly more effective practical means of vindicating the rights of the affected employees than individual litigation or arbitration, and finds that the disallowance of the class action will likely lead to a less comprehensive enforcement of overtime laws for the employees alleged to be affected by the employer's violations, it must invalidate the class arbitration waiver to ensure that these employees can 'vindicate [their] unwaivable rights in an arbitration forum.'
> (*Ibid*.)
>
> The *Gentry* majority expressly noted that "the kind of inquiry a trial court must make is similar to the one it already makes to determine whether class actions are appropriate.
> (*Ibid*.)

The dissent in *Gentry*, consisting of Justices Baxter, Chin and Corrigan, concluded that the majority's holding was contrary to the Federal Arbitration Act and the California Arbitration Act which the dissent characterized as favoring full implementation of arbitration agreements. The dissent also factually distinguished *Gentry* from *Discover Bank* on the grounds that the arbitration agreement in *Gentry* was "voluntary" since the employee had 30 days to opt out of the agreement, while the arbitration agreement in *Discover Bank* was part of a unilaterally imposed bill stuffer notice with no opt-out right. (*Id*. at 474.) The dissent also disagreed with the majority as to the potential drawbacks of individual arbitration of employment overtime claims and that the arbitration agreement and class-wide waiver in *Gentry* were essentially exculpatory in nature.

Implications for the future

The 4 to 3 split in *Gentry* and *Discover Bank* mirrors similar splits in other recent Supreme Court decisions concerning the enforceability of arbitration agreements. *(See, e.g., Little v. Auto Stiegler, Inc.* (2003) 29 Cal.4th 1064 (4 to 3 split regarding controlling standard for enforceability of arbitration agreement permitting one-sided appeal of damage awards in employment termination case.) The question arises as to how long we can expect the division of viewpoints within the Court regarding the enforceability of class action arbitration waivers to favor consumer and employee rights.

Even a minor alteration in the Court's current composition could lead to drastically different results. If but a single justice in the current majority leaves the Court for any reason and is replaced by another justice that sides with the minority, there is nothing – other than a vote of the Legislature or electorate – to stand in the way of the wholesale destruction of class actions in this state through industry's vigorous insertion of class action waivers in consumer or employee contracts.


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