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PAGA: The California Supreme Court Finds a Loophole in Federal Arbitration Act Preemption

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The United States Supreme Court consistently has enforced arbitration agreements. Such agreements, the Court has held, are protected by the Federal Arbitration Act, and they can trump an individual's right to bring or participate in a class action. Now, however, the California Supreme Court has found an exception to FAA preemption in California's Private Attorneys General Act. That Court held in *Iskanian v. CLS Transportation LA, LLC*, that signatories to arbitration agreements cannot bring or join traditional class actions — but they can avoid FAA preemption for certain categories of cases by restyling their claims under PAGA.

The Backdrop Of FAA Preemption

The U.S. Supreme Court consistently has held that the FAA protects arbitration agreements, including in the employment context. *See, e.g., Gilmer v. Interstate/Johnson Lane Corp.*, 500 U.S. 20 (1991) (Age Discrimination in Employment Act); *Circuit City Stores, Inc. v. Adams*, 532 U.S. 105 (2001) (California Fair Employment and Housing Act).

The Court several times also has considered the relationship between a private arbitration agreement and a class action. In *Stolt-Nielsen, S.A. v. AnimalFeeds International Corp.*, 559 U.S. 662 (2010), the Court stated that an arbitration agreement silent on the availability of class actions normally cannot be construed to allow them. One year later, in *AT&T Mobility, LLC v. Concepcion*, 131 S. Ct. 1740 (2011), the Court enforced an arbitration agreement that by its terms prohibited class actions, even though California state law prohibited class-action waivers. The FAA preempts any state-law rule that "stands as an obstacle" to enforcing an arbitration agreement "according to its terms." Arbitration can provide the exclusive means for enforcing rights even under federal statutes that commonly are enforced through class or collective actions, the Supreme Court held. In *CompuCredit Corp. v. Greenwood*, 132 S. Ct. 665 (2012), a putative class action arising under the federal Credit Repair Organizations Act, the Court enforced an arbitration agreement because the federal statute only had provided for, but did not require, judicial enforcement. If Congress intends in a particular statute to foreclose arbitration, it must do so clearly, the Court explained. Most recently, in *American Express Co. v. Italian Colors Restaurant*, 133 S. Ct. 2304 (2013), the Court enforced a class waiver in an antitrust case arising under the Sherman Act, even though the costs of arbitrating would overwhelm the amount that any individual claimant could recover.

PAGA's Structure

Meanwhile, however, plaintiffs in California (especially wage-hour plaintiffs) increasingly sued under PAGA, Labor Code section 2699 *et seq*. An empoyee initiates a PAGA claim by giving written notice to the employer and California Labor and Workforce Development Agency, describing the facts and theories supporting the allegation of a Labor Code violation. If the agency notifies the employee and the employer that it does not intend to investigate, or if the agency fails to respond within 33 days, the employee may bring a civil suit against the employer, seeking civil penalties. In reality, the agency almost invariably declines to investigate, so the employee's letter to LWDA normally is the precursor to a private civil suit. If the employee recovers any money, whether by judgment or settlement, PAGA provides that 75% is owed to the State; the plaintiff and other aggrieved employees are entitled to keep 25%.

Iskanian: PAGA Claims Avoid FAA Preemption

The two phenomena — the prevalence of FAA-protected predispute arbitration agreements, and the rise of PAGA litigation — were on a collision course. Could a private arbitration agreement trump a PAGA representative action? Employers contended that a PAGA representative action functionally was the same as a class action: a civil suit brought to recover money for persons in addition to the plaintiff himself. It logically followed, according to employers, that the *Concepcion* rule applied, and that the FAA preempted the state-law right to recover for others under PAGA. Plaintiffs, on the other hand, contended that PAGA is a suit in the name of the State of California, and that a private arbitration agreement cannot foreclose a state's law-enforcement scheme. Numerous state and federal lower courts wrestled with those competing arguments and reached divergent rulings.

Iskanian resolved that conflict, at least for now. The California Supreme Court first held that private arbitration agreements were unenforceable as a matter of state law, based on Civil Code section 1668 (which prohibits "contracts which have for their object . . . to exempt anyone from responsibility for his own fraud, or willful injury") and Civil Code section 3513 (which states that "a law established for a public reason cannot be contravened by a private agreement"). "A prohibition of representative claims frustrates the PAGA's objectives," the Court declared.

There remained, however, the question whether the FAA displaced the state-law rule. The Court held that the FAA did not do so. "[T]he FAA aims to ensure an efficient forum for the resolution of private disputes, whereas a PAGA action is a dispute between the employer and the state Labor and Workforce Development Agency," the Court explained. The U.S. Supreme Court's arbitration precedents generally involved private disputes between one person or entity and another. PAGA, the Court held, is different: "Simply put, a PAGA claim lies outside the FAA's coverage because it is not a dispute between an employer and employee arising out of their contractual relationship. It is a dispute between an employer and the *state*, which alleges directly or through its agents — either the Labor and Workforce Development Agency or aggrieved employees — the employer has violated the Labor Code." The PAGA action "is fundamentally a law enforcement action designed to protect the public and not to benefit private parties"; "an aggrieved employee's action under the [PAGA] functions as a substitute for an action brought by the government itself." Because "the state is the real party in interest," it logically follows that "*every* PAGA action . . . is a representative action on behalf of the state." That forecloses the FAA-preemption argument, the Court concluded. "[T]he FAA aims to promote arbitration of claims belonging to the private parties to an arbitration agreement. It does not aim to promote arbitration of claims belonging to a government agency, and that is no less true when such a claim is brought by a statutorily designated proxy for the agency as when the claim is brought by the agency itself."

The Court also considered an issue not raised in the petition for review, and that most observers (and certainly the *amici curiae*) did not think was presented in the case: whether PAGA violates the constitutional principle of separation of powers. The question was whether the state unconstitutionally delegated to private attorneys the responsibility to enforce the law. The Court upheld PAGA's constitutionality, declaring that any other rule would "interfere with a legitimate exercise of legislative authority aimed at accomplishing the important public purpose of augmenting scarce government resources for civil prosecutions."

The Court did, however, make two holdings favorable to employers. First, the Court held (as virtually every lower court already had done) that its 4-3 decision in *Gentry v. Superior Court*, 42 Cal. 4th 443 (2007), was overruled by later U.S. Supreme Court cases. *Gentry* had held that private arbitration agreements generally were unenforceable to the extent that they prohibited class actions. *Concepcion* and the other cases superseded that holding, the Court acknowledged; the class waiver was effective even if class actions were a desirable judicial enforcement mechanism.

Second, the Court joined almost every other court to consider the issue and held that the National Labor Relations Board had incorrectly decided *D.R. Horton, Inc.*, 357 NLRB No. 184 (2012). The NLRB had held that the National Labor Relations Act prohibits agreements that foreclosed class actions, but the California Supreme Court held that the NLRB had failed correctly to apply the Supreme Court's FAA precedents. (Justice Werdegar dissented on this point, saying that "Today's class waivers are the descendants of last century's yellow dog contracts," in which employees promised not to join a union as a condition of hire.) The majority did, however, note that an arbitration agreement could be unenforceable if it would lead employees reasonably to conclude that they could not file NLRB unfair labor practice charges.

The Court declined to resolve, and left open for lower-court decision on remand, exactly what would happen in Iskanian going forward. Iskanian was bound to arbitrate his individual claims, and the employer must answer the representative PAGA action in some forum. The Court did not decide whether the claims would proceed in separate forums: court, for the PAGA claim, and arbitration, for the individual claim. If the action proceeded in two forums, the Court did not decide whether the arbitration would be stayed while the civil action proceeded.

What To Do Now

A petition for U.S. Supreme Court review is likely in *Iskanian*, and the High Court (in that case or some other) may well provide the last word. Unless and until the U.S. Supreme Court takes up the issue, California employers must grapple with the California Supreme Court's decision.

The most obvious result is that employer motions to compel individual arbitration and foreclose PAGA claims now will fail. And disputes will arise even in cases that are not PAGA actions. In an individual case, plaintiffs may be expected to contend that an arbitration agreement that purports to foreclose PAGA representative actions violates public policy and/or is unconscionable, and should not be enforced. The employer will respond that the PAGA provision is irrelevant in an individual case, and that the dispute should be compelled to arbitration. Plaintiffs will contend in response that it should not matter what the instant dispute is about; the legality of an agreement should be assessed at the formation of the agreement, so it does not matter if the instant dispute happens not to be a PAGA lawsuit. The employer alternatively will contend that the PAGA provision should be severed under normal severability rules, particularly given the legal uncertainty that preceded *Iskanian*. Plaintiffs, on the other hand, will search the arbitration agreement for each and every provision that might be

unenforceable. If they find any, plaintiffs will contend that there are too many unenforceable provisions to sever. Substantial litigation over the enforceability of pre-*Iskanian* agreements is likely.

Employers also must evaluate how to draft new arbitration agreements going forward:

- Should they immediately redraft their agreements to remove language that purports to foreclose PAGA representative actions? Or should they await final word on the issue from the U.S. Supreme Court? Reasonable clients will resolve that issue different ways, in consultation with their employment counsel.
- What drafting devices can be employed to maximize the chances of enforceability? Paul Hastings will make available to its clients upon request, and without charge, a model arbitration agreement to consider as a starting point in drafting an arbitration program designed for each client's unique needs.

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