Arbitration of commercial disputes has become commonplace in every field of American business. Banks and their depositors; hospitals and their patients; builders and homeowners are all signing arbitration agreements as a matter of routine, and they get disputes resolved in binding arbitration, rather than in the courts. But dispute resolution between companies and their own employees through arbitration is a different and very controversial subject. The controversy is framed by the compulsory nature of most employment arbitration (that is, the employer mandates an agreement to arbitrate as a condition of employment) and the loss of the right to trial by jury. These are also features of all commercial arbitration, of course, so this does not explain the vehement and inflamed rhetoric heard only in opposition to employment arbitration.

The real basis for the objectors, this author believes, is that arbitrators rarely if ever award preposterous sums of punitive damages, while many juries do. This relative freedom from absurd results reduces the plaintiffs’ lawyers leverage to extort unreasonable settlements to avoid exposure to the occasional—but devastating—multi-million dollar jury verdicts¹.

California employers have increasingly adopted compulsory arbitration over the past decade, largely to avoid run-away jury verdicts. Some surveys estimate that 25% of California employers require arbitration as a condition of employment. Plaintiff’s lawyers, civil rights groups and other employee advocates have become increasingly shrill in their opposition to this practice.

In California, the issue recently came to a head in the California Supreme Court’s decision in Armendariz v. Foundation Health Psychcare Services, Inc. (Cal. Supreme Court, 2000 Cal. LEXIS 6120, decided August 24, 2000). This decision gives the high court’s approval to compulsory employment arbitration but attaches significant conditions to what are acceptable terms within an arbitration program. This decision will be discussed in more detail below.

¹ For example, a San Francisco jury last month awarded $132 million to 21 employees of Interstate Bakeries Corp. based on their claims of derogatory racial comments, assignments to undesirable jobs and being passed over for promotions. $120 million of this total was punitive damages. Most of the victorious workers remain employed by the company.
The question for employers now is whether compulsory arbitration—with all its new conditions—is still a better alternative than civil litigation in the court system. While this decision ensures the jury-avoidance feature of arbitration, the new conditions negatively impact many other features—such as speed, lower transactional costs and finality—that were always strong selling points for arbitration.

One drawback to compulsory employment arbitration is the frequency and cost of collateral litigation over the threshold issue of arbitrability itself. Few plaintiffs or their lawyers will concede that any arbitration agreement is binding on their claims. They do not want to lose their right to a jury, after all, and the leverage this gives them. Employers usually have to litigate first over whether they can enforce the agreement at all. For example, the Armendariz case was litigated for __ years all the way to the Supreme Court simply on the threshold issue of arbitrability. The merits of the plaintiffs’ claims and the employer’s defenses remain unexplored, and will now be decided in court many years after the events in dispute occurred. The lack of clear guidance by the Supreme Court on many points in this recent case is sure to increase, rather than resolve, disputes over these threshold questions and many procedural issues as well.

In short, the Supreme Court has made employment arbitration look more like conventional civil litigation, and thereby diminished its advantages.

**WHAT ARMENDARIZ DECIDED:**

The two plaintiffs in Armendariz were supervisors who were laid off after less than one year’s employment when their positions were eliminated. They sued, claiming that they had been sexually harassed and that they were terminated because of their “perceived and/or actual sexual orientation (heterosexual)”. Both employees had signed applications forms which included an arbitration clause and separately executed employment arbitration agreements. The agreements said the workers would, 1) arbitrate all disputes which arose out of their employment or its termination; 2) submit to arbitration under the California Arbitration Act, and 3) limit their claim for damages to lost wages up to the date of any arbitration award. No other remedies, such as reinstatement, injunctive relief or punitive damages were available under the arbitration agreement.

The trial court held that the arbitration agreement was unconscionable because it was too one sided: It required the employees to arbitrate their claims, but allowed the employer to sue if the employer had any claims against the employees. Second, the agreement limited damages to back pay only, so the employees could not sue for punitive damages and reinstatement, as they could in a court action for discrimination. The trial court also noted that the standard California Arbitration Act provisions under which this dispute was to be decided provided for no discovery whatsoever. In light of all these unfair elements, the court refused to endorse the arbitration agreement.

The Court of Appeals disagreed, holding that the agreement was acceptable except for the limitation on damages. It declared that the damage provision should be stricken from the agreement but that the remainder of the agreement should be upheld.

The California Supreme Court disagreed in part with both lower courts. The Supreme Court **upheld the general rule that compulsory arbitration of employment disputes can be lawfully imposed on employees.** This central and crucial ruling was in considerable doubt
before the court’s decision in Armendariz. Some lower courts in California had taken such a dim view of compulsory arbitration that they were reaching out to find any number of reasons to refuse to endorse it across the board. This Supreme Court therefore gives employers a green light to develop and implement fair arbitration procedures—and to require agreement as a condition of employment.

In this central ruling, the California Supreme court disagreed vigorously with a number of rulings from the federal Ninth Circuit Court of Appeals which has jurisdiction over federal claims in California and the western states. The Ninth Circuit’s rulings, which are also contrary to the views of most other federal appellate courts, are themselves subject to review by the U.S. Supreme Court in a case that will probably be decided next term. Circuit City Stores, Inc. v. Adams (9th Cir. 1999) 194 F.3d 1070, certiorari granted May 22, 2000, [120 S. Ct. 2004].

In effect, California employers can now feel secure that they can enforce a fair arbitration agreement if they are sued by an employee in the California court system. If the dispute is initiated or transferred to a federal court in California, however, that federal district court would be obliged to follow the anti-arbitration rulings of the Ninth Circuit. This state-federal split may encourage plaintiff’s counsel to find a federal basis for jurisdiction (such as by suing under Title VII of the Civil Rights Act, rather than the California Fair Employment and Housing Act) to avoid being pushed into arbitration and losing the opportunity for jury trial. More collateral litigation is sure to follow until this state-federal legal dispute is resolved.

**What Conditions Does Armendariz Impose?**

In Armendariz, the California court tied all of its rulings to the fact that the plaintiffs had sued under the California Fair Employment and Housing Act (“FEHA”), a statute which prohibits discrimination on the basis of sex and many other grounds. This statutory basis for the claims is important to analysis of the impact of Armendariz. First, the court stated that parties who are involved in a contractual dispute may decide for themselves whether they want to waive certain rights (such as the rights to all available remedies), but that statutory rights (such as under the FEHA), are non-waivable. Because important statutory rights are non-waivable, the analysis of the Supreme Court was presumably different than it would have been had the employees here simply sued for breach of contract.

The court held that FEHA claims could be subjected to compulsory arbitration only if the arbitration provided at least the following minimum safe guards:

1. **No Limitation on Remedies:** Since the FEHA provides remedies such as punitive damages, attorneys’ fees and reinstatement, the arbitration agreement may not place any limitations on the rights of the plaintiffs to seek those damages (non-waivable rights). Any damages limitations would be contrary to public policy, unlawful and unenforceable.

   Many employers have over recent years attempted to place limitations on the amount of damages in their arbitration agreements. It is now clear that in California any caps damages or elimination of a whole category of damages would be ineffective and allow the employee to sue despite having signed an arbitration agreement.

2. **Adequate Opportunity for Discovery is Required:** Part of the simplicity and speed of arbitration is because little or no discovery is allowed. Civil litigation provides for
virtually unlimited rights to take depositions, send interrogatories, demand production of
documents, etc. In traditional arbitration, discovery is limited to issuing subpoenas for records
and even this is done under the arbitrator’s scrutiny.

The Armendariz court held that severe limitations on discovery, at least in FEHA
discrimination claims, would create such a negative burden on the plaintiffs that this would make
the arbitration agreement unlawful. The court held, “…adequate discovery is indispensable for
the vindication of FEHA claims.” Even though the arbitration agreement in question here
provided for no discovery, the court finessed the issue by simply saying that adequate discovery
was impliedly allowed under the agreement. Therefore, even if the arbitration agreement is
silent as to discovery rights, at least when an FEHA discrimination claim is brought, both sides
would be allowed to do some form of discovery. The exact scope and amount of discovery is
uncertain but the court suggest it should be determined by the arbitrator and subject to limited
judicial review.

As a practical matter, the Armendariz court’s ad hoc expansion of discovery in arbitration
negates one of the principal advantages of arbitration--its relative speed and lower expense.

3. Written Arbitration Awards and Judicial Review Are Required: Again,
traditional arbitration results in a award by an arbitrator which simply states who wins, who
pays and how much. No explanations, findings of facts or conclusions of law are required in
traditional arbitration. Again, this is a key element to its speed and simplicity. Previously, the
California courts have upheld the powers of arbitrators to reach awards without including any
reasoning or facts in their decisions.

In Armendariz, however, the court held that--again because of the FEHA discrimination
claim--that a reasoned and written arbitration decision is required. The rationale for this new
requirement is that the courts need to see a written decision (briefly stating the factual
determinations and the legal basis for the rulings) so that the courts can review the decision of
the arbitrator.

This simple wrinkle in traditional arbitration rules actually signals a fairly radical change
from prior practice. Arbitration awards have traditionally been viewed as virtually unreviewable.
There is no appeal\(^2\). The matter is final when the arbitrator rules. All that is left is for the
arbitration award to be converted into a judgment and then the losing party pays. This is a key
element of the simplicity and speed of the system. Indeed, the lack of review of an arbitrator’s
award has always been the hallmark of arbitration; the parties agree in advance to give up the
right of appeal--and the precision and the certainty that goes with it--in order to streamline the
process.

Here, the Armendariz court grafts the requirement of judicial review onto an arbitration
system in which such review had previously been anathema. Worse, the court admits that it is
not going to “articulate precisely what standards of judicial review are sufficient”. Instead, they
let that wait for other cases.

\(^2\) Arbitration awards must be upheld except in extreme circumstances, such as corruption, fraud or serious misconduct by the
arbitrator; where the arbitrator clearly exceeded his powers (which does not mean just being wrong on the facts or law); or where
the parties are not allowed to present evidence. Cal. Civil Code sec. 1285.2.
By ornamenting the top of the arbitration tree with an ill-defined judicial review process, the Supreme Court makes arbitration considerably less attractive to many employers. The finality of an arbitrator’s decision will no longer be certain. The unsuccessful plaintiff has as much right to seek judicial review as does the losing employer. This will increase the cost of arbitration, sometimes considerably. With an eye towards judicial review, the parties will certainly want a transcript of the proceedings to be prepared by a court reporter. At a cost of roughly $1,500 to $2,000 per day, the transcription costs alone can add a considerable amount to the overall cost of the arbitration process. Also, the arbitrator will spend hours or days drafting a careful explanation of his ruling, with correct legal citations etc., and will bill additional fees for this work. And, as noted below, that cost will be borne by the employer.

4. **Arbitration Fees Are Now to Be Paid by the Employer, Not Shared With the Employee:** The arbitration agreement in this case was silent on the subject of how the fees and costs would be split between the parties. In many commonly used arbitration agreements, the agreement calls for a fifty-fifty split. Other agreements say that both parties will pay their share of the costs as the arbitration proceeds but that the arbitrator can re-allocate the costs and fees between the parties as part of his award “as justice requires”. None of these alternatives are acceptable any longer under the *Armendariz* ruling.

The significant cost of private arbitration—contrasting with “free” access to courts—had become a major bone in the throat of plaintiffs’ lawyers. Is it fair, they argued, to compel an employee to give up his constitutional right to a jury and then charge him thousands of dollars in arbitration fees too? A number of lower courts agreed this was unfair, and refused to enforce arbitration agreements simply because arbitration required the complaining employee to pay half the costs of the arbitration process. Arbitrators, who are most often retired judges, charge anywhere from $250 to $400 per hour. If a panel of three arbitrators is called out by the agreement (a provision employers would be wise to avoid), the costs triple. Doing the math, a five-day arbitration hearing before the average retired judge would cost something in the range of $14,000 ($350 x 5 days x 8 hours). The arbitrator’s time all is billed, including time spent for pre-arbitration hearing conferences (e.g., to resolve discovery disputes), reviewing briefs, researching legal points and now, for preparing a reasoned statement of the award. Employers should therefore budget $15,000 to $25,000 for the arbitration costs of an average employment case. This does not take into account the parties’ own attorneys’ fees, which will now include discovery time and, most likely, the cost of litigating the collateral issues, discussed above.