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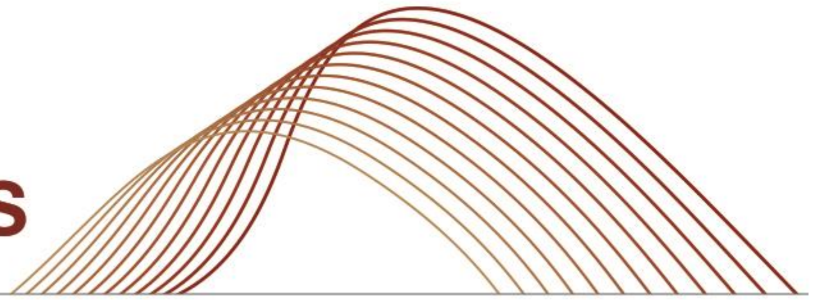

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Wage Claims After OTO v. Kho*: Are Arbitration Agreements Enforceable?*

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The California Supreme Court recently addressed—again—the enforceability of an arbitration agreement of an employee who sought to recover allegedly unpaid wages through California's administrative process.[1] The Court concluded, over a vigorous dissent, that under the facts of the case before it, the arbitration agreement was not enforceable. In doing so, the Court may have set the stage for yet another intervention by the United States Supreme Court.

Case Summary

Factual Background

Ken Kho worked as a service technician at an automobile dealership known as OTO. Three years into Kho's employment, a low-level HR employee approached Kho at his workstation and presented him with several documents to sign immediately. Kho had no opportunity to read the documents, and the HR employee did not explain their contents or provide copies for Kho to retain. Instead, Kho was required to sign on the spot.

Kho had signed a two-page arbitration agreement containing an acknowledgment of at-will employment. The arbitration promise appeared in a dense, single-spaced, page-long paragraph printed in an extremely small font. It provided that, subject to limited exceptions, almost all employment-related claims by either party must be submitted to binding arbitration before a retired judge. The arbitration allowed full discovery, pleadings, rules of evidence, and motion practice in accordance with California's rules of civil litigation. The clause did not address allocation of arbitration costs explicitly but stated that statutory code and case law would control.

After Kho was discharged, Kho filed a complaint for unpaid wages with the Labor Commissioner. Upon Kho's request, the Labor Commissioner set a date to conduct a "Berman hearing," an administrative procedure to recover unpaid wages.[2] One business day before the hearing, OTO petitioned to compel arbitration and stay the proceedings. OTO did not appear at the hearing and instead requested via facsimile that the hearing be taken off calendar. The hearing officer declined and proceeded to award Kho $102,912 in unpaid wages and $55,634 in liquidated damages, interest, and penalties.

OTO appealed, seeking *de novo* review in the Superior Court. The Labor Commissioner represented Kho on appeal. The trial court vacated the Labor Commissioner's award because it was improperly held in OTO's absence. However, the trial court also held that the arbitration agreement at issue was both procedurally and substantively unconscionable. The court of appeal reversed, holding that while the agreement contained an "'extraordinarily high' degree of procedural unconscionability," the

agreement was not substantively unconscionable. Therefore, OTO could enforce the arbitration agreement and bypass the Berman hearing process.

The California Supreme Court granted review.[3]

General Unconscionability Principles

California unconscionability law is well developed. An arbitration agreement is unenforceable only where both substantive and procedural unconscionability exist; it is not enough that one may exist without the other.[4] In analyzing unconscionability, California courts employ a "sliding scale" test. Where there is minimal procedural unconscionability, the party opposing arbitration must show a high level of substantive unconscionability (or *vice versa*).[5]

Whether an agreement is procedurally unconscionable depends on whether there is "'oppression' arising from an inequality of bargaining power," or "'surprise' arising from buried terms in a complex printed form."[6] Time-of-hire agreements or post-hire agreements imposed as a condition of employment or continued employment, respectively, often are nonnegotiable ("adhesive," in legal parlance), but are frequently enforced, absent other factors.[7]

Substantive unconscionability concerns "the fairness of an agreement's actual terms and . . . assessments of whether they are overly harsh" or "so one-sided as to shock the conscience."[8] For an employment arbitration agreement to be enforceable, it must meet certain minimum requirements to ensure that substantive rights afforded by statute are not waived. Specifically, an arbitration agreement is enforceable if it provides for: (i) a neutral arbitrator; (ii) a written decision subject to limited judicial review; (iii) payment by the employer of all costs unique to arbitration; (iv) adequate discovery; and (v) recovery of all statutory remedies.[9] Where an employee waives the right to a Berman process, "'[a]n agreement's failure to provide an employee with an accessible and affordable arbitral forum for resolving wage disputes may support a finding of unconscionability.'"[10]

The **OTO** *Court Held the Agreement Was Unconscionable*

The California Supreme Court found OTO's arbitration agreement to be both procedurally and substantively unconscionable and therefore unenforceable.

Procedural Unconscionability

With respect to procedural unconscionability, the Court found that the agreement created oppression and surprise. The Court viewed the agreement as procedurally unconscionable in part because Kho was forced to sign it to retain a job he had held for three years. Moreover, the agreement was "presented to Kho in his workspace," with "[n]either its contents nor its significance . . . explained," by a "low-level employee" which "creat[ed] the impression that no request for an explanation was expected and any such request would be unavailing."[11] Further, because Kho earned piece-rate compensation, any time he spent reviewing the agreement would have been unpaid. The Court concluded that, by having the HR employee wait for Kho to sign the documents, OTO "conveyed an expectation that Kho sign them immediately, without examination or consultation with counsel" and "that negotiation efforts would be futile."[12] OTO did not provide Kho a copy of the agreement for his records. These facts, the Court found, supported a clear finding of oppression.

The Court also found the element of surprise in how the arbitration provisions were conveyed. The text was "visually impenetrable" as a page-long paragraph in small font with complex sentences "filled with statutory references and legal jargon."[13] The provision for allocation of costs merely referred Kho to legal authorities that a layperson would be unable to decipher.

Thus, the Court found that the "document itself and the manner of its presentation did not promote voluntary or informed agreement to its terms" and, therefore, it was "virtually impossible" to conclude that Kho voluntarily waived his Berman rights and agreed to arbitration.[14]

Given the "exceptionally strong" degree of procedural unconscionability present, the Court noted that "even a relatively low degree of substantive unconscionability may suffice to render the agreement unenforceable."[15]

Substantive Unconscionability

While acknowledging that, in general, the waiver of Berman process is not per se unconscionable, the Court held that, here, OTO's agreement was substantively unconscionable, given the "unusually coercive setting in which this bargain was entered" and considering the "terms of what Kho gave up and what he received in return."[16]

Several factors led the Court to find substantive unconscionability. First, the agreement provided no explanation of how Kho would initiate arbitration or locate an arbitrator, or even that commercial providers of arbitration services existed. Second, the arbitration agreement required proceedings to follow a civil litigation framework, including formal pleadings, discovery demands, dispositive motions, and technical rules of evidence, which Berman hearings do not follow. Navigating such complexity could deter claimants from bringing wage claims at all. Third, the complexity of the litigation-like arbitral process contemplated by the agreement effectively would require the average claimant to hire counsel. The Court concluded that OTO's arbitral framework, considered in the context of the identified procedural shortcomings, was not sufficiently accessible or affordable for wage claimants. Kho "surrendered the full panoply of Berman procedures and assistance" of the Labor Commissioner, and "[w]hat he got in return was access to a formal and highly structured arbitration process that closely resembled civil litigation if he could figure out how to avail himself of its benefits and avoid its pitfalls."[17] Thus, the arbitral framework lacked both the "speedy, informal, and affordable" benefits of the Berman process, and the usual "efficiencies and cost savings often associated with arbitration."[18]

The Court declared that its analysis was consistent with federal law, because it said that its holding "rests on generally applicable unconscionability principles."[19]

The Dissent

In a lengthy dissenting opinion, Justice Ming Chin rejected the unconscionability analysis and conclusions of the six-justice majority, citing both state-law principles and Federal Arbitration Act preemption.[20] He found the majority's conclusion "that an arbitration agreement is substantively unconscionable—and therefore unenforceable—precisely because it prescribes procedures . . . carefully crafted to ensure fairness to both sides" is "hard to grasp and counterintuitive."[21] The FAA "precludes the majority from invalidating this arbitration agreement based on its subjective view that, for the purpose of 'vindicati[ng]' employees' 'statutory rights,' the prescribed arbitration procedure is not as effective as the statutory Berman procedure."[22] FAA preemption and the savings clause require that the "unconscionability standard be . . . the same for arbitration and nonarbitration agreements" and be applied "evenhandedly" without "disfavor[ing] arbitration" or "rely[ing] on the uniqueness of an agreement to arbitrate as a basis for a state-law holding that enforcement would be unconscionable."[23] "By refusing to enforce the arbitration agreement based on its view that the arbitration procedure is less advantageous for Kho and other employees than the Berman procedure, the majority runs afoul of these governing principles. . . . By insisting that the arbitration agreement have more features comparable to those of the Berman procedure, the majority is 'frustrat[ing]' the FAA's 'purpose to ensure that private arbitration agreements are enforced according to their terms.'"[24]

What's Next?

The majority opinion may not be the last word. Justice Chin's dissenting opinion demonstrated that the FAA preempts state-law anti-arbitration rules, and the U.S. Supreme Court may again have to intervene to remind the California courts of the FAA's primacy. The U.S. Supreme Court in *Buckeye Check Cashing, Inc. v. Cardegna*[25] reaffirmed that an arbitration agreement's enforceability may not "turn[] on" a state's "judgment concerning the forum for [a] state-law cause of action."

In fact, Justice Ginsburg's opinion for the Court in *Preston v. Ferrer*[26]—an 8-1 decision that the OTO majority opinion did not cite, let alone deal with—should have been controlling. A fee dispute arose between television personality Alex Ferrer (better known as "Judge Alex") and his attorney, one Preston. California's Talent Agencies Act specifies that the Labor Commissioner is to adjudicate in the first instance disputes between agents and the talent they represent. The losing side then can request a trial de novo in the Superior Court. The process is similar to the Berman hearing process at issue in OTO.

Ferrer and Preston had an arbitration agreement. Ferrer contended that the dispute could not be arbitrated at all because of the Talent Agencies Act, or in the alternative that any arbitration had to await the Labor Commissioner's exercise of its primary jurisdiction. The Supreme Court rejected Ferrer's claim, citing the FAA's provision that arbitration contracts are valid, irrevocable, and enforceable, "save upon such grounds as exist at law or in equity for the revocation of any contract."[27] The Court held that the FAA preempted the Labor Commissioner's exercise of primary jurisdiction. "A prime objective of an agreement to arbitrate is to achieve 'streamlined proceedings and expeditious results,'" the Court noted.[28] The Act reflects Congress' "intent 'to move the parties to an arbitrable dispute out of court and into arbitration as quickly and easily as possible.'"[29]

Ferrer's position—which insisted on the exhaustion of the Talent Agencies Act's administrative remedy—could not be squared with congressional policy, the Court declared. "Requiring initial reference of the parties' dispute to the Labor Commissioner would, at the least, hinder speedy resolution of the controversy."[30] As a result, Preston was free to—and was required to—present his claim against Ferrer to an arbitrator at the earliest possible time.[31] The Court summarized its holding: "When parties agree to arbitrate . . ., *the FAA supersedes state laws lodging primary jurisdiction in another forum, whether judicial or administrative*."[32]

Why should a Labor Commissioner Berman hearing differ, for FAA preemption purposes, from a Labor Commissioner Talent Agencies Act fees hearing? The *OTO* majority offered no answer, and the U.S. Supreme Court may well have to supply it.

Practical Take-Aways in the Interim

While the California Court's FAA reasoning is dubious, U.S. Supreme Court intervention cannot be counted upon. Fortunately, nothing in *OTO* should trouble careful California employers. Most wage claims are relatively small (Kho's was an aberration), and the cost-free Berman hearing to adjudicate them may not be materially inferior to—and indeed for many employers may be preferable to—an arbitration that the employer must pay for.

Employers, however, will want to review their arbitration agreements to ensure that *OTO* cannot be cited as a ground to invalidate an arbitration agreement entirely, for other kinds of claims. There is no single prescribed drafting solution to cater to *OTO*, but employers might consider provisions like these for their arbitration agreements:

- "Nothing in this Agreement prevents Employee from filing or recovering pursuant to a complaint, charge, or other communication with any federal, state or local governmental or law enforcement agency."
- "Nothing in this Agreement requires arbitration of claims that as a matter of law (after application of FAA preemption principles) cannot be made subject to a predispute arbitration agreement."

For cases arising under arbitration agreements without language of this kind, employers should consider:

- Waiving arbitrability for wage claims subject to Berman hearings.
- Insisting that courts sever any supposedly offending provision(s) of the arbitration agreement, so as not to (as one case put it) "throw the [arbitration] baby out with the bath water."

Employers also will want to review the procedural steps used to present and obtain arbitration agreements. The *OTO* majority clearly was bothered by what it called the "oppressive circumstances present here."[33] Indeed, the court noted that "the same contract terms might pass muster under less coercive circumstances . . . . Had [OTO] set out the terms of its agreement in a legible format and fairly understandable language, or had it given Kho a reasonable opportunity to seek clarification or advice, this would be a different case."[34] While no one aspect likely will be determinative, employers may want to consider details such as:

- The appearance of the agreement (*e.g.*, font size).
- The understandability of the arbitration language.
- The length of time employees have to review the agreement.
- The employee's opportunity to ask questions.
- The employee's opportunity to consult counsel.
- The availability to the employee of a copy of the executed agreement.

OTO may well be another in a line of California cases that the U.S. Supreme Court ultimately resolves. But in the meantime, *OTO* provides employers with a reminder to assess the status of their arbitration agreements, and the procedures used to obtain them.

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[1] *OTO, LLC v. Kho*, 2019 Cal. LEXIS 6241 (2019).

[2] A Berman hearing is an administrative hearing conducted by a deputy labor commissioner to resolve unpaid wage disputes. In a Berman hearing, pleadings are limited to a complaint and answer, no discovery is available, and all relevant evidence is admitted. The hearing officer may cross-examine parties and explain issues to them as needed. A party may appeal the Labor Commissioner's decision to the Superior Court for *de novo* review. The Labor Commissioner may elect to represent financially disadvantaged claimants in appeals and in enforcement of judgments.

[3] The Court originally granted review to decide whether a litigation-like arbitral scheme can constitute a sufficiently accessible and affordable process for parties. However, the Court did not provide a definitive conclusion on this issue because it found that, under the facts of the case, OTO's arbitration agreement was unconscionable and therefore unenforceable—thus rendering moot any analysis of the sufficiency of the arbitration procedure outlined in the agreement.

[4] *E.g., Armendariz v. Found. Health Psychcare Servs., Inc.*, 24 Cal. 4th 83, 114 (2000) (both forms of unconscionability must be present to defeat contract formation).

[5] *Id.* at 114 ("[T]he more substantively oppressive the contract term[s], the less evidence of procedural unconscionability is required to come to the conclusion that the term is unenforceable, and vice versa.").

[6] *McManus v. CIBC World Mkts. Corp.*, 109 Cal. App. 4th 76, 87 (2003) (citation omitted).

[7] *See OTO*, 2019 Cal. LEXIS 6421, at *17-19. For example, the California Supreme Court previously had enforced an arbitration agreement where the employee was told at the time of hire, "'[S]ign it or no job.'" *Baltazar v. Forever 21, Inc.*, 62 Cal. 4th 1237, 1241 (2016).

[8] *OTO*, 2019 Cal. LEXIS 6421, at *16, *24 (internal citations and quotation marks omitted).

[9] *Armendariz*, 24 Cal. 4th at 90-91, 103-13.

[10] *OTO*, 2019 Cal. LEXIS 6241, at *13 (quoting *Sonic-Calabasas A, Inc. v. Moreno*, 57 Cal. 4th 1109, 1146 (2013) ("*Sonic II*")).

[11] *Id.* at *19-20 (internal quotation marks omitted).

[12] *Id.* at *20.

[13] *Id.* at *21.

[14] *Id.* at *23.

[15] *Id.* at *25, *34.

[16] *Id.* at *35.

[17] *Id.* at *35.

[18] *Id.* at *28-29.

[19] *Id.* at *35.

[20] 9 U.S.C. § 1, *et seq*.

[21] *OTO*, 2019 Cal. LEXIS 6241, at *45.

[22] *Id.* at *45-46.

[23] *Id.* at *106-07 (internal quotation marks omitted).

[24] *Id.* at *108 (internal citations omitted).

[25] 546 U.S. 440, 446 (2006).

[26] 552 U.S. 346 (2008).

[27] 9 U.S.C. § 2.

[28] 552 U.S. at 357 (quoting *Mitsubishi Motors Corp. v. Soler Chrysler-Plymouth, Inc.*, 473 U.S. 614, 633 (1985)).

[29] *Id*. (quoting *Moses H. Cone Mem'l Hosp. v. Mercury Constr. Corp.*, 460 U.S. 1, 22 (1983)).

[30] *Id.* at 358.

[31] *Id.*

[32] *Id.* at 359 (emphasis added).

[33] *OTO*, 2019 Cal. LEXIS 6241, at *2-3.

[34] *Id*. at *34-35.

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