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No Exceptions: How the Legitimate Business Justification for Unconscionability Only Further Demonstrates California Courts' Disdain for Arbitration Agreements

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Davis v. O'Melveny & Myers[1]

I. INTRODUCTION

In *Davis v. O'Melveny & Myers*, the Ninth Circuit Court of Appeals considered whether an arbitration agreement adopted by a law firm and distributed to its employees was enforceable. When interpreting an arbitration agreement, how the contract doctrine of unconscionability should be applied by state courts, is an essential element of this case. While the Federal Arbitration Act ("FAA") has been interpreted to preempt any state law in conflict with it, state laws governing the necessary foundation to revoke a contract remain unaffected. In considering these principles, state courts have applied the doctrine of unconscionability to arbitration agreements in the employment context with varying degrees of scrutiny. Given the number of arbitration agreements that have been struck down in different jurisdictions, whether this variance in each state's doctrine of unconscionability as applied to arbitration agreements should be permitted is a question that should be resolved to achieve uniformity in employer-employee arbitration law. In *Davis v. O'Melveny & Myers*, the Ninth Circuit relied on how California courts have found unconscionability in arbitration agreements in order to declare an arbitration agreement unenforceable. Unfortunately, this conclusory analysis of the court only provides more fuel for critics who believe California is imposing special burdens on the enforcement of arbitration agreements deserving of FAA preemption.

II. FACTS AND HOLDING

The law firm of O'Melveny & Myers ("O'Melveny") adopted and distributed to its employees a Dispute Resolution Program ("DRP") on August 1, 2002.[2] The policy became effective three months after its distribution and bound all employees who were hired by, or continued to work for, the firm on or after Novem-

1. 485 F.3d 1066 (9th Cir. 2007).

2. *Id.* O'Melveny is a law firm with fourteen offices worldwide, including five in California. O'Melveny & Myers LLP, http://www.omm.com (last visited Nov. 1, 2008). California law governs this dispute because the employee who is a party to this dispute was employed in California. *O'Melveny & Meyers*, 485 F.3d at 1070.

ber 1, 2002.[3] The DRP covered most employment-related claims and also did not allow employees to file or initiate administrative actions with the exception of complaints of discrimination to the Equal Employment Opportunity Commission ("EEOC"), the California Department of Fair Employment and Housing ("DFEH"), the New York Human Rights Commission, or "any similar fair employment practices agency."[4] The DRP also excludes some specific types of claims, including "claims by [O'Melveny] for injunctive relief and/or other equitable relief for violations of the attorney-client privilege or work product doctrine or the disclosure of other confidential information."[5] The DRP contained a notice provision, which required notice and a demand for mediation within a year from when the basis of the claim is or should have been known.[6] If the claim was not filed within that period it would be deemed to be waived.[7] The policy also contained a confidentiality clause which precluded mentioning to anyone outside of the dispute "the content of the pleadings, papers, orders, hearings, trials, or awards" or even "the existence of a controversy and the fact that there is a mediation or an arbitration proceeding."[8]

Jacqueline Davis ("Davis") was an employee of O'Melveny at the time the DRP was distributed, and she received the policy.[9] The parties performed under the policy for less than one year, and Davis never officially questioned the policy.[10] On February 27, 2004, Davis filed an action alleging that O'Melveny failed to pay overtime for working through lunch and rest periods and for other work exceeding eight hours per day and forty hours per week, and for the denial of rest and meal periods in violation of the Federal Fair Labor Standards Act ("FLSA").[11] Davis also alleged violations of the California Labor Code and sought a declaration that the DRP is unconscionable.[12] Moreover, Davis argued that O'Melveny's enforcement of its provisions and other allegedly illegal behavior were unfair business practices under California's Unfair Business Practices Act.[13] In response, O'Melveny moved to dismiss the action and to compel arbitration.[14]

Before the United States District Court for the Central District of California, O'Melveny argued that the DRP was not unconscionable or, in the alternative, that California's doctrine of unconscionability is preempted by the FAA because it subjects arbitration agreements to special requirements.[15] The district court agreed with the arguments of O'Melveny including that the three months of notice

3. *Id.*
4. *Id.* at 1071.
5. *Id.*
6. *Id.*
7. *Id.*
8. *Id.*
9. *Id.* at 1070. Davis had been employed as a paralegal at a Los Angeles office of O'Melveny since June 1, 1999, and continued to work for the firm until July 14, 2003. *Id.*
10. *Id.*
11. *Id.*
12. *Id.*
13. *Id.*
14. *Id.* at 1071.
15. O'Melveny & Meyers v. Davis, No. 07-647, 2007 WL 4103979, at *6 (U.S. Nov. 15, 2007) (petioner's motion for *certiorari*). The case of *Armendariz v. Foundation Health Psychcare Services,* 6 P.3d 669 (Cal. 2000), was cited as prominently illustrative of California's doctrine of unconscionability. *Id.*

satisfied any oppression concerns and found that the DRP was not procedurally unconscionable.[16] Thus, the district court upheld the DRP and granted O'Melveny's motion to compel arbitration.[17]

Davis appealed the order of the district court.[18] On appeal, the Ninth Circuit was asked to determine whether the DRP was procedurally and substantively unconscionable, and whether any unconscionable provisions were severable from the DRP.[19] The Ninth Circuit reversed the order of the district court and remanded, holding that because the DRP was procedurally unconscionable and contained four substantially unconscionable terms: "(1) the 'notice' provision, (2) the overly-broad confidentiality provision, (3) an overly-broad 'business justification' provision, and (4) the limitation on initiation of administrative actions," the arbitration agreement could not be severed from the DRP or rewritten by the court and, as a result, the entire DRP was unenforceable.[20]

III. LEGAL BACKGROUND

A. The Enforcement of Arbitration Agreements in the Employer/Employee Context

The FAA has been interpreted broadly by the United States Supreme Court to apply in state courts and preempt any state law found to be in conflict with it.[21] The FAA has been construed as revoking state authority over some aspects of arbitration clauses by providing a uniform set of arbitration rules, but the states have maintained control over determining whether the arbitration provision is enforceable under their own state laws.[22] The relevant language for this reservation of state power is found in the language of Section 2 of the FAA, which states that written arbitration provisions are valid and enforceable "save upon such grounds as exist at law or in equity for the revocation of any contract."[23] The Supreme Court, in interpreting this provision, has found that state law may be applied to arbitration agreements only if that law was intended to govern general issues of contract enforcement.[24] Thus, state courts could apply contract defenses such as unconscionability when determining whether an arbitration agreement is

16. *O'Melveny & Meyers*, 485 F.3d at 1074.
17. *Id.* at 1071.
18. *Id.*
19. *Id.* at 1072-81, 1084. Neither party questioned whether the court or an arbitrator should decided whether the DRP was unconscionable. *Id.* at 1072. The Court determined that because the arbitration agreement in question was only part of the many conditions of Davis' employment, the legality of other conditions of her employment would not be affected by upholding or striking the arbitration agreement or severing any of its terms and as such the question of unconscionability was for a court to decide. *Id.* (citing Nagrampa v. MailCoups, Inc., 469 F.3d 1257, 1264 (9th Cir. banc 2006)).
20. *Id.*
21. *See* Southland Corp. v. Keating, 465 U.S. 1, 15-16 (1984).
22. *See* Perry v. Thomas, 482 U.S. 483, 492 n.9 (1987).
23. 9 U.S.C. § 2 (2006).
24. *See* Doctor's Assocs., Inc. v. Casarotto, 517 U.S. 681, 686-87 (1996) (citing *Perry*, 482 U.S. at 492 n.9).

unenforceable, but could not determine enforceability using state laws that apply only to arbitration agreements.[25]

As employment contracts remain substantially subject to state law, the agreements present courts with issues concerning the application of these contract defenses in the employer/employee context.[26] When available, employee-plaintiffs have used state contract doctrines to avoid employer-drafted arbitration clauses and bring their claims into court by invoking the "worn out, lame, and otherwise forgotten doctrine of unconscionability."[27] How courts apply these standards in evaluating arbitration provisions in employment situations differs among jurisdictions.[28] At one end of the spectrum, the Seventh Circuit has the tendency to uphold employment contracts as written, including the arbitration clauses, because "[o]ne aspect of personal liberty is the [job applicant's] entitlement to exchange statutory rights for something valued more highly—employment."[29] At the other end of the spectrum is the Ninth Circuit, which has been noted as one of the most prominent jurisdictions that has a strong tendency to invalidate arbitration clauses on the grounds of unconscionability.[30] Within the Ninth Circuit, it has been the California courts which have been the most closely scrutinized for determining arbitration provisions to be unconscionable under too liberal a standard.[31]

Under California law, both procedural and substantive unconscionability must be present in order for a court to exercise its discretion and refuse to enforce an agreement or clause under the doctrine of unconscionability.[32] These elements are analyzed on a sliding scale—the more substantively oppressive a term of the agreement, the less evidence of procedural unconscionability is required for the court to find that the term is unenforceable, and vice versa.[33] Once a court has found unconscionability in the arbitration agreement, California law gives the court discretion to sever the unconscionable provision or refuse to enforce the

25. *Id.* at 687.

26. *See* Daniela Caruso, *Contract Law and Distribution in the Age of Welfare Reform*, 49 ARIZ. L. REV. 665, 674-75 (Fall 2007) (citing Michael Schneidereit, *A Cold Night: Unconscionability as a Defense to Mandatory Arbitration Clauses in Employment Agreements*, 55 HASTINGS L.J. 987, 996 (2004).

27. *Id.* at 675 (citing JAY M. FEINMAN, UN-MAKING LAW: THE CONSERVATIVE CAMPAIGN TO ROLL BACK THE COMMON LAW 107 (Beacon Press 2004) ("Feinman concedes that in extreme cases '[t]here continues to be much litigation about the unconscionability of particular arbitration schemes, and courts do strike down some as too one-sided.'")).

28. Caurso, *supra* note 26, at 676-77.

29. *Id.* at 677 (citing Metro E. Ctr. for Conditioning & Health v. Qwest Commc'ns Int'l, Inc., 294 F.3d 924, 929 (7th Cir. 2002); Perdue v. RBC Mortgage Co., 156 F. App'x 824 (7th Cir. 2005)); *see e.g.*, Harris v. Green Tree Fin. Corp., 183 F.3d 173, 183-84 (3d Cir. 1999) (finding an arbitration provision not unconscionable that gave the drafter unilateral control of whether a dispute is arbitrated or litigated).

30. Caruso, *supra* note 26, at 677.

31. *See generally*, Stephen A. Broome, *An Unconscionable Application of the Unconscionability Doctrine: How the California Courts are Circumventing the Federal Arbitration Act*, 3 HASTINGS BUS. L. J. 39 (Fall 2006).

32. Armendariz v. Found. Health Psychcare Servs., 6 P.3d 669, 690 (Cal. 2000).

33. Nagrampa v. Mailcoups, Inc., 401 F.3d 1024, 1027 (9th Cir. 2005) (rehearing en banc granted, 413 F.3d 1024 (9th Cir. 2005), *rev'd* on other grounds, 469 F.3d 1257 (9th Cir. 2006)).

contract as a whole.[34] The court, in exercising this discretion, looks to whether the "central purpose of the contract is tainted with illegality" or if "the illegality is collateral to [the agreement's] main purpose."[35] If the illegality is collateral and the provision can be removed from the contract through severance, then severance is appropriate.[36] If the central purpose of the contract is tainted with illegality, then the contract as a whole cannot be enforced.[37]

B. Procedural Unconscionability Under California Law

California courts' test of procedural unconscionability is rooted in the state's adoption of a provision of the Uniform Commercial Code which evaluates procedural unconscionability on the basis of two factors: "oppression" and "surprise."[38] "Oppression" stems from "an inequality of bargaining power" leading to an absence of negotiation or choice; "surprise" arises when the terms of the agreement are hidden.[39] In *Ingle v. Circuit City Stores, Inc.*, the Ninth Circuit stated that "when a party [with] greater bargaining power than [the other] party presents the weaker party with a contract without a "meaningful opportunity to negotiate, 'oppression and, therefore, procedural unconscionability, are present.'"[40] The court, in addressing an employment contract containing an arbitration clause found that because the employer had presented the employee with the arbitration agreement on an "adhere-or-reject basis," the agreement was procedurally unconscionable.[41] This test, which has been adopted by California courts, has been criticized as providing that "adhesion alone" can be enough for the courts to find that the agreement is procedurally unconscionable.[42] Nevertheless, even if the agreement is found to be procedurally unconscionable, the court must still analyze the agreement for substantive unconscionability.

C. Substantive Unconscionability Under California Law

In California, the analysis for establishing substantive unconscionability focuses on the terms of the arbitration agreement and whether those terms are "overly harsh" or "one-sided."[43] Applying this analysis, California courts have said that the overriding consideration is the mutuality of the obligation to arbitrate.[44] In

34. Circuit City Stores, Inc. v. Adams, 279 F.3d 889, 895 (9th Cir. 2002); CAL. CIV. CODE § 1670.5(a) (West 2008).

35. *Circuit City Stores Inc.*, 279 F.3d at 895 (quoting *Armendariz*, 6 P.3d at 696-97).

36. *Armendariz*, 6 P.3d at 696.

37. *Id.*

38. A & M Produce Co. v. FMC Corp., 186 Cal. Rptr. 114, 121-22 (Cal. Ct. App. 1982).

39. *Id.* at 122.

40. 328 F.3d 1165, 1172 (9th Cir. 2003) (citations omitted).

41. *Id.* The court noted that the employee "had no meaningful opportunity to opt out of the arbitration agreement, nor . . . any power to negotiate [any] terms of the agreement." *Id.*

42. *See* Broome, *supra* note 31, at 60-63.

43. Armendariz v. Found. Health Psychcare Servs., 6 P.3d 669, 690 (Cal. 2000).

44. Nyulassy v. Lockheed Martin Corp., 16 Cal. Rptr. 3d. 296, 311 (Cal. Ct. App. 2004) (stating that in determining whether a mandatory arbitration clause is substantively unconscionable, the fact that it imposes a unilateral obligation to arbitrate is of the greatest significance overall); *Armendariz*, 6 P.3d at 690.

Armendariz v. Foundation Health Psychare Services, Inc., the California Supreme Court stated that arbitration agreements lacking mutuality are unfairly one-sided and thus unconscionable absent a "reasonable justification for such one-sidedness based on 'business realities.'"[45] In reaching this conclusion, the court noted the various disadvantages that would be imposed on an employee trying to pursue a claim against his employer under the Fair Employment and Housing Act, ("FEHA") and the advantages arbitration provides employers.[46] This mutuality test is the most common means employed by the courts of appeals in California to void arbitration agreements.[47]

In addition, the court in *Ingle* stated that "under California law, a contract to arbitrate between an employer and an employee . . . raises a rebuttable presumption of substantive unconscionability."[48] The court found that, under California law, the burden is on the employer to prove that the effect of an arbitration agreement is mutual with respect to an individual employee.[49] In order to rebut this presumption, the employer must demonstrate that the arbitration agreement maintains the "modicum of bilaterality" that California law requires.[50] The *Ingle* court made a point to note that its conclusions were consistent with federal policy in that the FAA "does not supplant state law governing the unconscionability of adhesive contracts."[51] Although jurists and commentators outside the state have criticized these unconscionability tests as biased against arbitrators, California courts have strictly adhered to these doctrines in recent cases.[52]

IV. INSTANT DECISION

In *Davis v. O'Melveny & Myers*, the Ninth Circuit was faced with the question of whether the DRP adopted by O'Melveny for its employees was unenforceable.[53] The court, in considering the issues presented, formulated the fundamental question as whether the DRP was both procedurally and substantively unconscionable.[54] The court first addressed the question of whether the DRP was procedurally unconscionability, and then it proceeded to examine each of the four provisions of the DRP that Davis challenged as substantially unconscionable.[55] Then the court reasoned that it must consider whether any provisions found to be "void

45. 6 P.3d. at 692.

46. *Id.* at 690.

47. *See* Broome, *supra* note 31, at 50-51 (stating that "in more than two-thirds of the Courts of Appeal cases finding arbitration provisions unconscionable, the basis was lack of mutuality.").

48. Ingle v. Circuit City Stores, Inc., 328 F.3d 1165, 1174 (9th Cir. 2003).

49. *Id.*

50. *Id.* at 1174 n.10.

51. *Id.* (citations omitted).

52. *See* Susan Randall, *Judicial Attitudes Toward Arbitration and the Resurgence of Unconscionability*, 52 BUFF. L. REV. 185, 207-09 (Winter 2004); Jeffrey W. Stempel, *Arbitration, Unconscionability, and Equilibrium: The Return of Unconscionability Analysis as a Counterweight to Arbitration Formalism*, 19 OHIO ST. J. ON DISP. RESOL. 757, 799-802 (2004).

53. 485 F.3d 1066, 1070 (9th Cir. 2007).

54. *Id.* at 1072-73. The Court stated that, under California law, a contractual clause is unenforceable if it is both procedurally and substantively unconscionable. *Id.* at 1072.

55. *Id.* at 1073-79.

may be severed from the rest of the DRP or whether . . . the DRP is unenforceable in its entirety."[56]

In her argument to the Ninth Circuit, Davis argued that the DRP was unconscionable because it imposed a strict one-year statute of limitations period from the occurrence of any injury for all state and federal claims.[57] Moreover, Davis argued that the confidentiality provision in the DRP was unfairly one-sided in that an employee or ex-employee was forbidden from disclosing to anyone that a mediation or arbitration is in process.[58] Davis argued that the DRP contained a provision that granted O'Melveny unconscionable one-sided access to litigate disputes in court, but the agreement forbade employees from exercising the same right for claims such as privacy and confidentiality.[59] In addition to these substantive unconscionability arguments, Davis argued that the DRP was procedurally unconscionable in that it was presented to O'Melveny employees "with no chance to bargain or negotiate, no chance to modify provisions, in a take it or quit manner."[60] In conclusion, Davis argued that because there was no severability provision in the DRP and the procedural and substantive unconscionability elements were met, the entire DRP was invalid.[61]

In opposition, O'Melveny argued that the three-month period between the announcement of the DRP and the talk effect provided employees with a meaningful choice over their employment and thus was not procedurally unconscionable.[62] In addition, O'Melveny argued that the one-year notice provision was not substantively unconscionable because California law has allowed far shorter periods and allows for parties to agree to reduce a relevant statute of limitations.[63] O'Melveny also contended that Davis' argument that the confidentiality provision is unconscionable "ignores that provision's savings clause, applies a reading far broader than the actual language permits, and interprets the provision in light of distinguishable cases from a very different context."[64] As for the provision pertaining to attorney-client privilege, O'Melveny justified the clause by arguing that it has ethical and contractual obligations to clients to protect privileged and confidential information from being disclosed.[65] Moreover, O'Melveny argued that Davis' arguments were baseless as to the substantive unconscionability of the DRP's applicability to certain administrative proceedings and as to the provision giving O'Melveny the right to seek judicial relief in certain circumstances.[66] Finally,

56. *Id.* at 1076.

57. Brief of Petitioner-Appellant Jacquelin Davis at 12, Davis v. O'Melveny & Myers, No. 04-56039 (9th Cir. Sept. 22, 2004).

58. *Id.* at 18-22.

59. *Id.* at 24-25.

60. *Id.* at 28.

61. *Id.* at 30-32.

62. Brief of Defendant-Appellee O'Melveny & Myers at 9, Davis v. O'Melveny & Myers, No. 04-56039 (9th Cir. Oct. 21, 2004).

63. *Id.* at 13-17. O'Melveny also made the argument which had been accepted by the district court that the notice provision was not a statute of limitations at all. *Id.* at 14-17.

64. *Id.* at 20.

65. *Davis*, 485 F.3d at 1080.

66. Brief of Defendant-Appellee at 21-23, Davis v. O'Melveny & Myers, No. 04-56039. O'Melveny cites *Armendariz's* "business realities" doctrine in making the argument that the confidential and privileged nature of O'Melveny's communications with its clients justifies the reservation of judicial remedies provision. *Id.* at 23-36.

O'Melveny argued that even if the DRP was procedurally or substantially unconscionable in any or some of its provisions, only those terms should be severed and the rest of the agreement should be upheld.[67]

In first considering the procedural unconscionability of the DRP, the court stated that the test should focus on "factors of oppression and surprise."[68] While the court acknowledged that the DRP and its terms were not hidden, that there was no evidence of undue pressure on employees, and that O'Melveny gave ample notice to employees of the policy and its terms, the court maintained that the DRP was "take it or leave it."[69] The court rejected O'Melveny's argument that the three-month notice satisfied procedural unconscionability concerns and stated that "the availability of other options does not bear on whether a contract is procedurally unconscionable."[70]

After finding procedural unconscionability, the court acknowledged that it must also find substantive unconscionability in the DRP before ruling the agreement unenforceable.[71] The court stated that substantive unconscionability focuses on the terms of the agreement and whether there is a lack of mutuality that is one-sided or oppressive so "as to shock the conscience."[72] The court first examined the notice provision of the DRP, which required an employee to demand mediation as a prerequisite to arbitration within one year of the alleged offense, or the employee would waive the claim forever.[73] As the provision dealt with employment-related statutory claims, the court found that the provision functioned as a statute of limitations and that the provision only benefited employers because the employer would be insulated from potential damages while an employee would forego the possibility of relief under the continuing violations doctrine.[74] Consequently, the court found the provision to be substantively unconscionable.[75]

Next, the court found that the confidentiality clause unconscionably favored O'Melveny.[76] In short, the court found that the clause was written too broadly.[77] The court determined that the clause would put O'Melveny in a far more superior position while hurting employee-plaintiffs since the employee would be restricted from even discussing the existence of the arbitration or mediation.[78] In addition, the court even posited that the clause could discourage enforcement of California Labor Code §232.5, which "forbids employers from keeping employees from

67. *Id.* at 26-29.

68. *O'Melveny & Myers*, 485 F.3d at 1073 (citing Soltani v. W. & S. Life Ins. Co., 258 F.3d 1038, 1042 (9th Cir. 2001)).

69. *Id.*

70. *Id.* at 1074 (citing Ingle v. Circuit Stores, 328 F.3d 1165, 1172 (9th Cir. 2003)).

71. *Id.* at 1075. (citing Armendariz v. Found. Health Psychcare Servs., 6 P.3d 669, 690 (Cal. 2000); Nagrampa v. MailCoups, Inc., 469 F.3d 1257, 1280-81 (9th Cir. banc 2006)).

72. *Id.* at 1075 (quoting Soltani v. W. & S. Life Ins. Co., 258 F.3d 1038, 1043 (9th Cir. 2001)).

73. *Id.* at 1076-77 ("An employee must give written notice of any Claim to the Firm . . . Failure to give timely notice of a Claim along with a demand for mediation will waive the Claim and it will be lost forever.").

74. *Id.* at 1076-77.

75. *Id.* at 1077-78.

76. *Id.* at 1078.

77. *Id.* at 1079.

78. *Id.*

disclosing certain 'working conditions' and from retaliating against employees who do so."[79]

The court determined the exemption for O'Melveny in the DRP for attorney-client privilege disputes to be too broad since "its plain language would allow O'Melveny to go to court to obtain any 'equitable relief' for the disclosure of any 'confidential information.'"[80] The court acknowledged that in certain cases, California law allows an employer to have an arbitration clause that allows the employer to preserve a judicial remedy even though the employee is not granted the same right.[81] This is an exception to the rule that a one-sided arbitration provision is unenforceable and arises when the provision is justified by a "legitimate commercial need" or "business reality."[82] However, in rejecting that proposition under the facts of this case, the court stated that California law has recently provided that "protecting against breaches of confidentiality alone does not constitute a sufficient justification."[83]

As to the provision in the DRP that prohibits most administrative actions, the court determined that the DRP was unenforceable in that it required arbitration of judicial actions seeking public injunctive relief such as actions under California's Labor Code and Unfair Business Practices Act.[84] The court's rationale was that California law provides that certain "public injunctions" are incompatible with arbitration.[85] Specifically, the court stated that an arbitration agreement "may not function so as to require employees to waive potential recovery for substantive statutory rights in an arbitral forum, especially for statutory rights established 'for a public reason.'"[86] After finding that employment rights under the FLSA and California's Labor Code are "public rights," the court found the inclusive bar to administrative actions in the DRP void "even given the listed exceptions for EEOC and DFEH complaints [in that it] is contrary to U.S. Supreme Court and California Supreme Court precedent."[87]

In conclusion, the court found that the unconscionable provisions could not be severed "without gutting the agreement."[88] The court acknowledged the "liberal federal policy" favoring arbitration agreements, but found that the unconscionable provisions were so entangled in the DRP that the agreement could not

79. *Id.*; CAL. LABOR CODE § 232.5 (West 2008).

80. *O'Melveny & Myers,* at 1081.

81. *Id.* at 1080 (citing Fitz v. NCR Corp. 13 Cal.Rptr.3d 88, 103 (Ca. Ct. App. 2004) ("[A] contracting party with superior bargaining strength may provide 'extra protection' for itself within the terms of the arbitration agreement if 'business realities' create a special need for the advantage. The 'business realities' creating the special need, must be explained in the terms of the contract *or factually established.*"(emphasis added)).

82. *Id.* (citing Armendariz v. Found. Health Psychcare Servs., 6 P.3d 669, 691 (Cal. 2000) ("[A] contract can provide a 'margin of safety' that provides the party with superior bargaining strength a type of extra protection for which it has a legitimate commercial need without being unconscionable.") (citations omitted)).

83. *Id.* at 1081 (citing Nagrampa v. MailCoups, Inc., 469 F.3d 1257, 1287 (9th Cir. banc 2006) ("California courts routinely have rejected [protecting proprietary information] as a legitimate basis for allowing only one party to an agreement access to the courts for provisional relief.")).

84. *Id.* at 1082.

85. *Id.* (citing Broughton v. Cigna Healthplans of Cal., 988 P.2d 67, 76-80 (Cal. 1999)).

86. *Id.* (citing Gilmer v. Interstate/Johnson Lane Corp., 500 U.S. 20, 28 (1991); *Armendariz,* 6 P.3d at 680-81).

87. *Id.* at 1082.

88. *Id.* at 1084.

stand without them.[89] The Ninth Circuit declared the arbitration agreement unconscionable under California law and reversed and remanded the district court's granting of O'Melveny's motion to dismiss and to compel arbitration.[90]

V. COMMENT

A. The Instant Court Exposed California's Disfavor of Arbitration Agreements by Treating the DRP as Presumptively Unconscionable

The *Davis* court had an opportunity to scrutinize the principles that the California courts and the Ninth Circuit have applied to arbitration agreements when determining enforceability. Specifically, the court was presented with an arbitration agreement that contained a notice provision, a confidentiality provision, a provision exempting the employer from arbitration and allowing injunctive actions for violations of attorney-client privilege or work product doctrine and other confidential disclosures, and a provision that generally prohibited an employee from initiating administrative actions. Moreover, presented with the interesting employment situation between a law firm and its employee, the court had an opportunity to dissect the "business realities" exception to "mutuality," a standard that some critics describe as a completely erroneous rule of unconscionability unique to California. However, instead of exploring new ground, the court relied on the major cases that have been the source of what has been called California's "cloaking [of its] inherent bias against arbitration in the 'unconscionability doctrine.'"[91] Consequently, the court only fueled the fire for those who argue that California's special rules for arbitration agreements should be preempted by the FAA.

The court adheres to the principles set forth in commonly cited cases without exploring how the rules set forth in those cases could be applied differently to the facts in the instant decision.[92] The "take it or leave it" or "mutuality" principle cited numerous times through the opinion reflects the court's willingness to view arbitration agreements differently than non-arbitration contracts.[93] This principle

89. *Id.*

90. *Id.*

91. Michael G. McGuinness & Adam J. Karr, *California's "Unique" Approach to Arbitration: Why This Road Less Traveled Will Make All the Difference on the Issue of Preemption Under the Federal Arbitration Act*, 2005 J. DISP. RESOL. 61, 79 (2005). It is noted that the authors of this article, at least at the time of its publication, were attorneys at the Los Angeles office of O'Melveny & Myers and specialized in labor and employment matters. *Id.* at 62 n. 1.

92. *See* Ingle v. Circuit Stores, 328 F.3d 1165, 1171-72 (9th Cir. 2003) (holding an arbitration agreement procedurally unconscionable because it was presented on an "adhere-or-reject basis"); Nagrampa v. MailCoups, Inc., 469 F.3d 1257, 128 (9th Cir. banc 2006) (finding procedural unconscionability because the arbitration clause in the franchise contract was presented on a take-it-or-leave-it basis).

93. *See, e.g.*, Christopher R. Drahozal, *Nonmutual Agreements to Arbitrate*, 27 J. CORP. L. 537, 544 (Summer 2002) (stating that "virtually all courts hold that the doctrine of mutuality of obligation does not preclude enforcement of nonmutual arbitration clauses") (citing, among other cases, Pridgen v. Green Tree Fin. Servicing Corp., 88 F. Supp. 2d 655, 659 (S.D. Miss. 2000) ("[M]utuality of obligation is not required for a contract to be enforceable. Therefore, the arbitration clause is not unenforceable."); Design Benefit Plans, Inc. v. Enright, 940 F. Supp. 200, 205 (N.D. Ill. 1996) ("[A]n arbitration clause, which compels one party to submit all disputes to arbitration but allows the other party the

raises a rebuttable presumption of unconscionability for arbitration agreements that is not found when the defense is raised for other contracts. Unconscionability in the context of contract law places the burden of proof on the party seeking to avoid the contract.[94] While this placement of the burden of proof carries over to the related concept of arbitration agreements, the mutuality principle goes further by creating a presumption of unconscionability that O'Melveny could only rebut by identifying a legitimate business justification for the provisions in the DRP. One case relied on by the court, *Ingle*, has been cited in numerous employment arbitration agreement cases and remains one of the main cases critics cite as going beyond the bounds of the FAA by creating a special unconscionability standard for arbitration agreements.[95] In addition to *Ingle*, the court relied on *Nagrampa* in asserting that, because Davis was simply a paralegal in a large law firm presented with the DRP on a "take it or leave it" basis, the arbitration agreement was procedurally unconscionable.[96] In analyzing substantive unconscionability, the court adhered strictly to the mutuality standards set forth in the *Armendariz* opinion and similar California opinions. As a result, the court examined the terms of the agreement without adequately exploring whether there was a reasonable business justification for the one-sidedness of the terms.

When a court bases its determination of unconscionability on the reasonableness of a contract provision, it "inject(s) an inappropriate level of judicial interference" into its analysis.[97] By treating the DRP in this case as presumptively unconscionable and procedurally unconscionable per se because of the employer-employee context, the court demonstrated its disfavor for arbitration agreements. This disfavor becomes even more evident when exploring how the court applied the mutuality doctrine and the "business realities" exception to the factual circumstances of instant case.

B. The Instant Court Failed to Adequately Examine the Business Realities Exception to the "Mutuality" Requirement of Arbitration Agreements

Since the *Davis* court relied heavily on cases that exemplify the unique unconscionability standards California courts impose on arbitration agreements when determining enforceability, the court did not adequately examine issues such as the applicability of the "business realities" exception. The question of whether the business justification exception applies should be examined based on the characteristics of the business operation rather than simply on the characteristics of the arbitration provision itself.[98] The court's reluctance to examine the exception in the context of the special needs of a law firm only further illustrates how im-

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choice of pursuing arbitration or litigation" would not be invalid when contract as a whole is supported by consideration.")).

94. *See* E. ALLAN FARNSWORTH, FARNSWORTH ON CONTRACTS § 4.28 (2d ed. 1990).

95. *See* McGuinness & Karr, *supra* note 91, at 81-84 (stating that *Ingle* "created a completely new rule of unconscionability" for arbitration agreements thus putting it in conflict with the FAA restriction on courts from submitting arbitration agreements to special scrutiny).

96. Davis v. O'Melveny & Myers, 485 F.3d 1066, 1075 (9th Cir. 2007).

97. Steven J. Burton, *The New Judicial Hostility to Arbitration: Federal Preemption, Contract Unconscionability, and Agreements to Arbitrate*, 2006 J. DISP. RESOL. 469, 486 (2006).

98. *See* Drahozal, *supra* note 93, at 555.

possible the mutuality standard or its exception is to meet for any employer. Rather than illustrating that there is some degree of objectivity to the unconscionability test used by California courts, the imposition of such an impossible standard when applying the exception only exemplifies how the mutuality doctrine goes beyond normal contract law unconscionability principles and inserts the biased views of the court. It has been widely argued that, in violation of the FAA, California courts place a higher burden on arbitration agreements in that courts do not apply the mutuality standard to normal contracts when determining enforceability.[99] Assuming that California courts continue to apply this standard for determining unconscionability in arbitration agreements, in order to be in compliance with the FAA, the courts should allow a feasible way for mutuality to be attained, or at the very least, a way for the exception to be met. When examining these agreements, courts need to take into account the realistic amount of flexibility employers need to manage their relationships with employees to effectively serve their business needs. However, considering the conscious disregard by the court for the legitimate business justifications present in the instant decision, the mutuality standard and the "business realities" exception prove almost impossible to satisfy in California.

In analyzing the "business realities" exception, the court cites *Armendariz*, which obtained the test for the "business realities" exception from the court in *Stirlen v. Supercuts, Inc.*[100] Accordingly, the text of *Stirlen* that gave rise to this test is important to examine. In significant phrasing, the *Stirlen* court stated that it agreed that "a contract can provide a 'margin of safety' that provides the party with superior bargaining strength a type of extra protection for which it has a legitimate commercial need without being unconscionable."[101] *Stirlen* also stated that an arbitration clause should be examined in the context of the industry in which it operates and considered with respect to the needs of the parties to it.[102] After this consideration, the court should determine whether the arbitration clause is "so extreme as to appear unconscionable according to the mores and business practices of the time and place."[103] In applying this test to the context of a law firm's contractual and ethical obligations to its clients, it is remarkable how a court could not find the standard satisfied when presented with a provision that protects against violations of the attorney-client privilege, work product doctrine, or the disclosure of other confidential information.

When considering the duties of confidentiality and privacy that a law firm is held to in conducting its business, it would seem that a law firm has a strong argument for being granted the extra protection mentioned in the *Stirlen* test.

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99. *See generally*, Broome, *supra* note 31. In the Empirical Analysis section of this article, Broome states that in a Westlaw search showing 114 cases in which the California Courts of Appeal examined an arbitration agreement for unconscionability, fifty-three of the agreements were held unconscionable and thus unenforceable; in thirteen, a provision of the agreement was found unconscionable and severed, and in forty-eight, the agreement was upheld by its terms. *Id.* at 44-46. In comparison, a Westlaw search showing forty-six cases before the same court where a non-arbitration contract was alleged to be unconscionable, forty-one of the contracts were upheld and only five were held to be unenforceable due to unconscionability. *Id.* at 46-49.

100. 60 Cal.Rptr. 2d 138 (Cal. Ct. App. 1997).

101. *Id.* at 148.

102. *Id.* at 152.

103. *Id.* (citing Williams v. Walker-Thomas Furniture Co., 350 F.2d 445, 449-50 (D.C. Cir. 1965)).

O'Melveny argued that it is foreseeable that a law firm could need a quick court order or injunction to stop a current or former employee from releasing privileged information.[104] The court countered that protecting against breaches of confidentiality alone does not constitute a sufficient justification.[105] Still, the court acknowledged that "[i]t may be that a provision allowing a law firm immediate access to a court for a limited purpose of seeking injunctive relief to protect confidential attorney-client information could constitute a legitimate business justification because such relief would fit into an unarbitrable category of 'public injunction.'"[106] In its own words, the court seemed to acknowledge that employers, and especially law firms, need to have the flexibility to regulate their relationships with employees in order to best serve the needs of their business, including protecting their clients' confidential information from unauthorized disclosure. Ignoring further inquiry into this proposition, the court found that the provision was too broad because it contained the phrase "the disclosure of other confidential information" following the language of attorney-client privilege and work product doctrine.[107] The conclusion that this court found this provision to be so one-sided as to view it as substantively unconscionable, without inserting some of its general prejudice against arbitration agreements, is suspect. It is noteworthy that no lower court in California has found any legitimate business justification sufficient to satisfy the exception to the strict mutuality standard.[108] Moreover, California holds its attorneys to a stricter duty than any other state not to reveal the confidential information of clients than any other state; thus California courts are clearly sensitive to privacy considerations in the legal context.[109]

The best explanation is that the "business realities" exception in California, with its inclusion of terminology associated with general contract law, provides nothing more than another illustration of how California courts hold arbitration agreements to a unique standard.[110] By referencing an exception to the doctrine of mutuality, which seemingly can be factually established by employers with legitimate business needs, the courts are at least making an attempt, albeit a poor one, to demonstrate that the test applied to arbitration agreements in California is as objective as the test imposed on non-arbitration contracts.[111] As the instant case

104. *Davis* v. O'Melveny & Myers, 485 F.3d 1066, 1080 (9th Cir. 2007).

105. *Id.* at 1081 (citing, Nagrampa v. MailCoups, Inc., 469 F.3d 1257, 1286 (9th Cir. banc 2006)).

106. *Id.* The Court stated that as far as it could determine the issue had not been addressed in a published California opinion. *Id.*

107. *Id.* The Court stated that the arbitration provision as written would allow O'Melveny "to go to court to obtain any 'equitable relief' for the disclosure of any 'confidential information.'" *Id.*

108. McGuinness & Karr, *supra* note 91, at 81.

109. Kevin E. Mohr, *California's Duty of Confidentiality: Is It Time for a Life-Threatening Criminal Exception?*, 39 SAN DIEGO L. REV. 307, 309 (Spring 2002). The article states that this is because California, which has not adopted the Model Rules, has no express exceptions to its duty of confidentiality. *Id.*

110. *See, e.g.*, U.C.C. § 2-302(2) (2003) ("When it is claimed or appears to the court that the contract or any clause thereof may be unconscionable the parties shall be afforded a reasonable opportunity to present evidence as to its commercial setting, purpose and effect to aid the court in making the determination."); RESTATEMENT (SECOND) OF CONTRACTS § 208, cmt. f "Law and fact" (1981).

111. *See* Richard L. Barnes, *Buckeye, Bull's-Eye, or Moving Target: The FAA, Compulsory Arbitration, and Common-Law Contract*, 31 VT. L. REV. 141, 173-74 (Fall 2006). The author, in discussing the legitimate business need exception to lack of mutuality, explains how the opinion in the *Armendariz* case spends a substantial amount of time trying to dispel the argument that arbitration was being "singled out." *Id.*

illustrates, however, this exception is not easily, if ever, met. The inclusion of an equitable relief provision that pertains to attorney-client privilege and other confidential information serves the interests of a law firm and its clients. The maintenance of this contractual and ethical relationship between attorney and client is a business need that is unique to the legal industry and warrants special consideration by a court when determining the enforceability of an arbitration provision. Should an employee divulge private client information, empanelling an arbitral tribunal would likely take too long to be effective and might not even have the power to issue preliminary injunctions.[112]

Unfortunately, the court in the instant decision did not explore in depth the interesting factual arguments for the "business needs" justification that a law firm arbitration agreement raises. Instead, the burden placed on the employer to rebut the presumption of unconscionability was once again too high for the agreement in question to be enforceable. When the only exception to such a strict test cannot be factually established, the exception serves no purpose and only shines more light on the shortcomings of the test itself. By adhering to this test without allowing any exceptions, courts in California are only continuing to demonstrate how the mutuality test is specific to arbitration agreements and thus outside of the parameters allowed to state court discretion by the FAA.

VI. CONCLUSION

California continues to demonstrate that there is considerable disagreement among jurisdictions as to the breadth of the "savings clause" in the FAA and how unconscionability should be determined in arbitration agreements.[113] The special treatment that California courts give to arbitration agreements illustrates the problems that can arise when courts, faced with employer-employee relationships, make judgments about the reasonableness of arbitration agreements. In particular, employers seeking to modify their relationships with employees through adopting dispute resolution programs are faced with an almost impossible standard of "fairness" to which other employment contracts are not subject.

In order for employers to have the flexibility to manage their relationships with employees to best serve their business needs, the unfair treatment California courts apply to arbitration agreements must be scrutinized and brought to an end. One solution would be for the Supreme Court to take up the issue.[114] Another solution would be to amend the FAA by removing consumer and employee contracts from the coverage of the statute, thus overruling the Supreme Court, and

112. *See* Burton, *supra* note 97, at 488 (citing Oakland Raiders v. Nat'l Football League, 81 Cal. Rptr. 2d 773, 778-79 (Cal. Ct. App. 1999)).

113. *See, e.g., id.* at 483-84 (stating that existing case law and dictum from the Supreme Court do not resolve the tension of whether courts are free to find an arbitration agreement unconscionable when the reasons disfavor arbitration because on one hand the justification for the finding is based on general contract law while on the other hand the reasons and consequences might be incompatible with the federal policy favoring arbitration).

114. *See* Nagrampa v. MailCoups, Inc., 469 F.3d 1257, 1313 (9th Cir. banc 2006) (Kozinski, J., dissenting) (stating "California courts have shown a lamentable tendency to hold the arbitration clauses in [standardized] contracts unenforceable. . . . I would not be the least surprised to see the Supreme Court of the United States soon take a close look at whether the unconscionability doctrine, as developed by some state courts, undermines important policies of the Arbitration Act.").

also by providing that pre-dispute arbitration agreements in these contracts will not be enforced.[115] The proposed "Arbitration Fairness Act," introduced in Congress in 2007, seeks to prohibit the enforcement of pre-dispute arbitration agreements in employment, consumer, and franchise cases, but the legislation still faces the obstacle of supporters of arbitration status quo who feel that the FAA does not need to be changed.[116] Unfortunately, the instant decision did not address any of these issues, nor did it provide a solution. Instead the *Davis* court only illustrated how California courts are willing to manipulate the facts of any employment relationship when assessing the enforceability of an arbitration agreement—no matter the legitimate business needs of the employer—to carry out the policy interests of the court.

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115. *See* David S. Schwartz, *If You Love Arbitration, Set It Free: How "Mandatory" Undermines "Arbitration,"* 8 NEV. L.J. 400, 422 (Fall 2007) (stating that the "specialized body of unconscionability doctrine" and other questions that the Supreme Court declines to answer every year would become insignificant if the FAA were amended to overrule *Moses H. Cone Memorial Hospital v. Mercury Construction Corp.*, *Southland Corp. v. Keating*, and *Mitsubishi Motors Corp. v. Soler Chrysler-Plymouth, Inc.*).

116. *See* Maureen A. Weston, *Preserving the Federal Arbitration Act by Reining in Judicial Expansion and Mandatory Use*, 8 NEV. L.J. 385, 397-99 (Fall 2007).