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Enforceability of Cost-Sharing Provisions in Arbitration Agreements

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The Supreme Court recently held in *Epic Systems v. Lewis*, 584 U.S. ___ (2018), that arbitration agreements which include waivers of employees' rights to bring class or collective actions are enforceable under the Federal Arbitration Act (FAA), and that the National Labor Relations Act (NLRA) does not override this principle in the FAA. Following *Epic* many employers are re-examining whether to include class action waivers in existing arbitration agreements, and further whether to adopt mandatory arbitration programs covering all of their employees.

Although the prospect of eliminating the risk of class actions weighs strongly in favor of adopting an arbitration program, employers who opt for an arbitration program should do so with their eyes wide open regarding the associated costs. Whereas in litigation, taxpayers cover the costs of the judge, the courthouse, and the court reporter, in arbitration the parties must allocate analogous costs of the tribunal among themselves.¹

To defray such expenses, employers sometimes consider requiring employees to bear some of the costs of arbitration. However, employers should be aware that courts have imposed significant limits on the enforceability of cost-sharing provisions in arbitration agreements. In this month's column, we discuss the landscape of cost-sharing provisions and the legal standards for enforceability. We also recommend how employers might draft agreements or design programs to maximize enforceability.

Legal Standards

Numerous courts have addressed whether allocating the costs of arbitration to employees provides a ground to invalidate the arbitration agreement or to require modification of the cost allocation. For example, courts have expressed willingness to invalidate arbitration provisions under federal law where costs allocated to employees prevent effective vindication of their federal statutory rights. Some courts refer to this as the "effective vindication exception" to the general policy favoring enforcement of arbitration. For example, in *Nesbitt v. FCNH, Inc.*, 811 F.3d 371 (10th Cir. 2016), the Tenth Circuit invalidated an arbitration agreement in its entirety based on the "effective vindication exception." *Nesbitt*, a student in massage therapy school, alleged she was a constructive employee of the school and entitled to

compensation under the Fair Labor Standards Act (FLSA) and applicable state wage and hour laws. Nesbitt was bound to an arbitration agreement incorporating the American Arbitration Association's Commercial Rules, which provided equal arbitration cost-sharing between the parties. Pursuant to the agreement, Nesbitt had to bear at least \$2,520.50 in arbitration fees – an amount she could not afford. The Court found that the fee-splitting provision substantially deterred vindication of federal statutory rights, and the fact that the arbitrator could have reallocated fees did not alleviate the court's concern. The Court reasoned that "it [wa]s unlikely that an employee in [the plaintiff's] position, faced with the mere possibility of being reimbursed for arbitrator fees in the future, would risk advancing those fees in order to access the arbitral forum." *Id.* at 378, 380-81.

Some courts have applied the "effective vindication exception" not to invalidate the entire arbitration agreement, but to invalidate and sever the cost-sharing provision itself. In *Morrison v. Circuit City Stores, Inc.*, 317 F.3d 646, 663 (6th Cir. 2003), the Court held that arbitration is not an effective or adequate substitute for litigation where a cost allocation provision would deter a "substantial number of potential litigants from seeking to vindicate their statutory rights." Accordingly, the Court invalidated and severed a cost-sharing provision that obligated an employee earning \$54,060 per year to pay \$1,622 in arbitration costs.

In contrast to *Nesbitt* and *Morrison*, courts sometimes allow arbitration with the possibility, but not the certainty, of cost-sharing among the parties in light of the arbitrator's ability to allocate costs at the end of the arbitration. For example, in *Zambrano v. Strategic Delivery Solutions, LLC*, No. 15 Civ. 8410, 2016 WL 5339552 (S.D.N.Y. Sept. 22, 2016), plaintiffs brought claims against their employer for violation of the FLSA and the New York Labor Law. The plaintiffs sought to demonstrate that a cost splitting provision would require each of them to bear half of the arbitration costs, amounting to an unaffordable expense of at least \$8,750 per employee. Accepting the plaintiffs' contentions as true, the court enforced the arbitration cost-sharing agreement and found plaintiffs' showing

to be overly speculative in light of the arbitrator's ability to reallocate costs. *Id.* at *7-8; *see also Barbieri v. K-Sea Transp. Corp.*, 566 F.Supp.2d 187, 195 (E.D.N.Y. 2008) (arbitrator's ability to reallocate costs made plaintiff's challenge too speculative to invalidate the arbitration clause).

In addition to the "effective vindication exception," courts also have scrutinized cost-sharing provisions under a variety of common-law contract principles. For example, in *Armendariz v. Foundation Health Psychcare Services, Inc.*, 24 Cal.4th 83 (Cal. 2000), the court considered whether public policy would invalidate allocation of expenses to an employee as a condition to arbitration of state statutory rights. In *Armendariz*, the plaintiff was subject to a mandatory arbitration agreement, but filed a claim in state court alleging wrongful termination under California's Fair Employment and Housing Act and based on tort and contract theories of recovery. Based on public policy, the court held that where an employee asserts an unwaivable statutory right subject to mandatory arbitration, the employer must bear "any type of expense that the employee would not be required to bear if he or she were free to bring the action in court." *Id.* at 110-11, 113. Unwaivable statutory rights are those established to benefit the public, such as statutes that protect against sexual harassment or discrimination. *Id.* at 100-01.

Courts also have analyzed whether cost-sharing requirements in arbitration agreements should be invalidated as unconscionable. In *Pinela v. Neiman Marcus Group, Inc.*, 238 Cal.App.4th 227, 254-55 (Cal. Ct. App. 2015), the Court found unconscionable an agreement pursuant to which the arbitrator merely had the power to impose costs on the employee. That risk, the Court reasoned, could "burden [an employee's] exercise of statutory rights." Thus, at least in this California court, the mere risk of the employee having to incur substantial arbitration fees and costs was sufficient for the Court to invalidate the agreement as unconscionable.

Other states' courts considering the enforceability of arbitration cost-sharing agreements employ a variety of tests which differ from the considerations advanced in *Pinela* and *Armendariz*. For example, in *Brady v.*

Williams Capital Group, L.P., 14 N.Y.3d 459 (N.Y. 2010), the New York Court of Appeals articulated a multi-factor test specifically to evaluate cost-sharing provisions in arbitration agreements. Guided by federal courts' considerations of the "effective vindication exception," New York state law requires courts to consider: (1) whether the employee is able to pay the arbitration fees and costs, (2) the expected cost differential between arbitration and court, and (3) whether the cost differential is so substantial as to deter claims in arbitration. *Id.* at 467. Courts that have applied this multi-factor test tend to focus on whether the employee is able to afford the costs of arbitration and whether the cost differential between arbitration and courtroom litigation is "prohibitively high." See, e.g., *id.* at 465, 466; *Suero v. Touro College*, 157 A.D.3d 478, 479 (N.Y. App. Div. 2018) (enforcing arbitration where employee failed to demonstrate that he would be "unable to afford" "prohibitively high" arbitration costs). In *Brady*, the Court found that an obligation to bear approximately \$21,150 in costs might render the cost allocation provision unenforceable, even though the employee earned over \$1.5 million in her prior six years of employment. 14 N.Y.3d at 463-64. The Court, therefore, remanded the case to the lower court to evaluate the cost-sharing provision under the three-factor test. *Id.* at 467-68.

Restrictions on cost-sharing provisions apply to agreements with both rank and file employees as well as executives, though issues of unconscionability or inability to pay may be less relevant with higher-earning parties. See *id.* at 463. Finally, if a court finds a cost-sharing provision unenforceable, courts vary in their treatment of the remainder of the arbitration agreement. Some courts will invalidate the arbitration agreement in its entirety, see, e.g., *Nesbitt*, 811 F.3d at 381, while other courts will permit arbitration with the caveat that the employer bear the fees and costs (sometimes even if there is no severability clause), see, e.g., *Brady*, N.Y.3d at 467-68; *Armendariz*, 24 Cal.4th 113, 121-27.

Applying the above standards, many employers have chosen to cover the costs of arbitration in full. One study from 2012 found that employers paid for 100%

of the costs in 95% of disputes in arbitration pursuant to mandatory, employer-promulgated programs.² Where individually negotiated agreements, such as executive employment agreements, provide for arbitration, the employee more frequently bears half of the arbitration costs. One study suggests that fees are split in 35% of employment disputes arising out of individually negotiated agreements that contain arbitration clauses, but even so, employers bear the full costs a majority of the time.³

Drafting Considerations

Needless to say, employers maximize the likelihood that their arbitration agreements will be enforced by agreeing to bear the full costs of arbitration. However, an employer may limit its assumption of costs to those not traditionally associated with a judicial forum, such as the arbitrator's fees and travel expenses. Accordingly, employers do not need to cover arbitral filing fees or expenses to the extent that such costs do not substantially exceed what it would cost the employee to file an action in court.

Employers who wish to take a more aggressive approach may consider conditional cost-sharing provisions, which give employees the opportunity to demonstrate a lack of sufficient means to prosecute claims based on the anticipated share of arbitration costs. Employers who choose to go this route, should also include a severability clause and stipulate in the agreement that the arbitrator, or possibly a court, can modify the arbitration cost allocation if it determines that a cost-sharing provision is unenforceable. To the extent the employer enters into an arbitration agreement with a highly compensated executive, the equal allocation of costs is much more likely to pass scrutiny.

Employers seeking to allocate some costs of arbitration to executive employees should be guided by the following simple but effective exemplar provision that may be included as part of a senior executive's employment agreement: "Except as provided by applicable law, the fees and expenses of the arbitration shall be shared equally by the executive and the corporation."

Employer Update

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¹ Lisa A. Nagele-Piazza, *Unaffordable Justice: The High Cost of Mandatory Employment Arbitration for the Average Worker*, 23 U. MIAMI BUS. L. REV. 39, 45-46 (2014).

² Alexander Colvin & Kelly Pike, *The Impact of Case and Arbitrator Characteristics on Employment Arbitration*

Outcomes, 15 (June 2012)

<https://digitalcommons.ilr.cornell.edu/cgi/viewcontent.cgi?article=1022&context=conference> (last accessed July 20, 2018);

see also Alexander Colvin & Mark D. Gough, *Comparing Mandatory Arbitration and Litigation: Access, Process, and Outcomes*, 35-36 (April 2, 2014)

<https://digitalcommons.ilr.cornell.edu/cgi/viewcontent.cgi?article=1059&context=reports> (last accessed July 20, 2018).

³ Colvin, *The Impact of Case and Arbitrator Characteristics on Employment Arbitration Outcomes*, 15, *supra* note 2.

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