Insights

INSIGHT: Ten Tips for Drafting Arbitration Clauses with Class Action Waivers in Independent Contractor Agreements

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Attorney Richard Reibstein with Locke Lord LLP writes about the good, bad, and ugly of arbitration agreements, and uses a number of recent cases to illustrate how companies can create good arbitration clauses and leave behind the bad or ugly.

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Companies that use independent contractors as part of their business model or to augment their workforce should not simply be asking themselves whether they have an arbitration clause in their independent contractor agreement. Instead, they should also be asking themselves, does our arbitration clause actually protect us and our customers from having to litigate class actions?

Both before and after the U.S. Supreme Court's decision last May in *Epic Systems Corp.*, which upheld mandatory arbitration agreements, many courts have upheld or struck down arbitration provisions based not on the law but rather on the language in the arbitration agreement drafted by the company. A well drafted arbitration clause will generally mean, with few exceptions, that a class action cannot be maintained and that each plaintiff's and class member's case must be individually litigated. A poorly drafted one will result in the company having to defend itself in a class action because the language deployed by the business did not take full advantage of the current state of the law. Some arbitration provisions can even needlessly impose contractual obligations or undesirable state laws upon the company.

Arbitration clauses with class action waivers are routinely challenged by plaintiffs' class action lawyers, who regard them as a huge impediment to their ability to vindicate worker claims including rights asserted by workers who allege they have been misclassified as independent contractors. In contrast, businesses using arbitration agreements view them as a means to curtail the misuse of class actions used to exact costly settlements in circumstances where only a few members of the class truly feel aggrieved.

Whether an arbitration agreement in an independent contractor or employment setting will bar a class action depends as much of the wording in the arbitration clause as the applicable law, which is in flux and continues to evolve. That reality strongly suggests that existing arbitration clauses used in independent contractor agreements should be reexamined and updated periodically in tandem with the company's effort to enhance its compliance with laws governing the use of independent contractors.

Three recent cases illustrate how companies can create good arbitration clauses in independent contractor agreements. These cases also provide the starting point for ten tips to minimize exposure to class and collective action lawsuits—and a key final takeaway for businesses that rely on independent contractors.

Berryman v. Newalta Environmental Services, Inc.

In this case, a solids control technician was referred by a staffing company, Smith Management and Consulting LLC, to its client Newalta, a company in the oil and gas industry. The technician filed a proposed class action lawsuit against Newalta Environmental, claiming that Newalta misclassified him and other similarly situated workers as independent contractors and failed to pay them overtime in violation of the federal Fair Labor Standards Act and the Pennsylvania Minimum Wage Act. Newalta filed a motion to compel arbitration based on the arbitration clause in the agreement between Smith Management and Berryman—an agreement to which Newalta was not a party.

On November 1, 2018, a federal court judge in Pennsylvania was presented with the question of whether the language in that contract not only provided for arbitration of all covered disputes between Berryman and Smith Management but also whether such disputes brought by Berryman against clients of Smith Management, including Newalta, were subject to the arbitration clause in the Smith Management/Berryman contract.

The court began its lengthy analysis by noting that the law of Texas, not Pennsylvania, applied, because that was the choice of law provision in the independent contractor contract signed by Berryman with Smith Management. The judge noted that under Texas law, there is a presumption against conferring third-party beneficiary status on non-contracting parties such as Newalta. The court further noted that Texas law requires a court to review the entire contract to determine if an arbitration clause confers third party beneficiary status upon a client of Smith Management. The court held that Newalta was a third-party beneficiary of the arbitration provision because of the language in the contract between Berryman and Smith Consulting that stated: "Arbitration shall apply to any and all Covered Claims, whether asserted by Contractor [Berryman] *against the Company [Smith Consulting] and/or . . . any Company Client*." No. 18-cv-793 (W.D. Pa. Nov. 1, 2018) (emphasis added).

What can a company learn from the court's decision in *Berryman*?

Tip No. 1. Make sure the arbitration clause specifically designates as third-party beneficiaries all of the clients and customers of the business.

If that had been the case in *Newalta*, there would have been little or no issue that the client/customer, Newalta, would have been able to make use of the arbitration clause as well, all but eliminating the risk of an adverse decision under state law court as to whether the presumption against third party beneficiary status could be overcome. Thus, for staffing and referral companies as well as businesses that engage independent contractors to provide services to key customers, the larger lesson from *Berryman* is simple: ensure your independent contractor agreements are updated and enhanced to benefit your customers and clients as well as yourselves.

In addition, third party beneficiary language in arbitration agreements (as well as employment agreements) can and should also cover other possible defendants as well as customers and clients.

Lamps Plus Inc. v. Varela

In late October, the U.S. Supreme Court heard oral argument in this case, which presented the Court with the issue of whether class arbitration is permitted when the parties' agreement contains an arbitration clause which is silent as to whether the parties authorized the arbitrator to conduct a class arbitration. The U.S. Court of Appeals for the Ninth Circuit had concluded that because of the absence of any language in the agreement pertaining to class arbitration, the contract was ambiguous, and under California contract interpretation principles, any ambiguities should be construed against the drafter of the agreement, which was Lamps Plus, the party seeking to avoid class arbitration.

Regardless of which way the Supreme Court rules, one of the Justices' remarks during oral argument was of particular note. Justice Ginsburg questioned the value of a ruling in favor of the plaintiff seeking class arbitration. She projected that if the Court rules in favor of the plaintiff and orders class arbitration in the case, lawyers across the U.S. will simply add a provision in arbitration agreements that class arbitrations are not authorized by the parties. Justice Ginsburg asked the following rhetorical question of the plaintiff's lawyer: "So, if let's say you're right, we're not doing very much, are we, because contracts will specifically say that class action [arbitration] is waived?" No. 17-988 (Oct. 29, 2018).

Tip No. 2. The lesson from *Lamps Plus* is rather obvious. Any arbitration agreement with a class action waiver should specifically recite that the arbitrator is not given authority to conduct class arbitration. If a company's arbitration agreement does not already include that language, it should certainly be included in future versions.

Portillo v. National Freight Inc.

This June, a New Jersey federal district court was presented with the question of what state's law applied in an independent contractor misclassification class action brought by truckers against a logistics/transportation company, National Freight, Inc. (NFI). The plaintiffs, truckers from Pennsylvania and Rhode Island, made deliveries to Trader Joe's stores throughout many East Coast states on behalf of NFI and claimed that NFI was liable for statutory wage/hour violations, unjust enrichment, and payment of their expenses as a result of allegedly being misclassified as independent contractors. The plaintiffs initially sued under Massachusetts law, but sought to amend their claims to be governed by New Jersey law, which was the choice of law cited in the parties' contracts. The defendants objected to the motion to amend, even though NFI selected New Jersey law in the contracts it had drafted and tendered to the truckers to sign, and urged the court to apply Pennsylvania law, which contains a more favorable test for independent contractor status than the standard in New Jersey.

The court reviewed the language contained in the Independent Contractor Operating Agreements and Lessor and Lease Operating Agreements entered between the parties. The court noted that the agreements had a choice-of-law provision designating New Jersey as the relevant and applicable body of law. The court then undertook a further analysis using "the most significant relationship" test and determined that New Jersey law did, in fact, apply to the claims brought by the truckers against NFI. The court found conflicting factors supporting usage of Pennsylvania law, which NFI favored, and New Jersey law, which the truckers favored. In reaching its conclusion, the court placed emphasis on the fact that NFI was the more sophisticated party and had drafted the contracts in which NFI elected to be bound by Jersey law, at least with regard to contract claims. No. 15-cv-7908 (D.N.J. June 11, 2018).

Tip No. 3. Businesses that use independent contractors can learn a lot from the *National Freight* case: avoid selecting a particular state's law as the parties' contractual "choice of law" if that state's law contains an unfavorable test for independent contractor status. There are a few states whose independent contractor laws are particularly "employee friendly"; thus, a company's choice of law selection in an independent contractor agreement should generally steer clear of those states. New Jersey is one such state. Its law became tilted toward employee status only in 2015, when the New Jersey Supreme Court issued its decision in *Hargrove v. Sleepy's, LLC*, as we noted in our blog post analyzing that decision.

Tip No. 4. The *National Freight* case also teaches businesses that have had independent contractor agreements in place for many years to keep tabs on changing laws and to modify any choice of law provision in such agreements when there has been an unfavorable change in the independent contractor laws of the state selected as the choice of law.

National Freight also raises the question: why didn't NFI have an arbitration clause with class action waiver in its independent contractor agreement with the truckers? Had it included such a provision, the case may well have been litigated in arbitration on an individual trucker basis and not in court as a class action.

What choice of law should businesses select in their arbitration agreements? That is a challenging question. Some state laws are less favorable toward independent contractor status than others; those should generally be avoided. In any event, plaintiffs' class action lawyers generally argue that a choice of law provision cannot override the law of the state of residence of the worker classified as an independent contractor or the law where the worker provided services under the independent contractor agreement.

Additional Tips on Drafting Arbitration Provisions in Independent Contractor Agreements

Tip No. 5. Make sure the arbitration clauses can withstand unconscionability arguments. Plaintiffs' class action lawyers in independent contractor misclassification and employment cases not only routinely challenge the language of arbitration agreements with class action waivers but also frequently argue that certain types of arbitration provisions are unconscionable under applicable state law.

Unconscionability arguments can derive from the high arbitrator fees imposed upon the workers treated as independent contractors, the inconvenience of a forum selection clause that designates a distant location where all disputes are to be resolved, a limitation on statutory or common law remedies, restrictions on discovery, and a host of other provisions in arbitration clauses that are overly favorable to companies. For example, only last week an appellate court ruled that an arbitration agreement was unconscionable under state law where it required the claimant to pay half of the costs of arbitration, included a limitation on relief, and contained an overly broad confidentiality provision that may impair the claimant's ability to interview witnesses outside of the formal discovery process. *Ramos v. Superior Court of San Francisco County*, No. A153390 (Cal. Ct. of App. Nov. 2, 2018).

Tip No. 6. Don't bury arbitration clauses deep within independent contractor agreements. Class action lawyers also argue that some arbitration provisions are non-consensual where employers "bury" arbitration provisions deep within independent contractor agreements without informing the worker that the agreement contains a section providing for arbitration of certain disputes.

Tip No. 7. Some state laws or judicial decisions require waivers of jury trials to be conspicuous. It is wise to place jury trial waivers in all capital letters, or bold type, or larger size typeface, and to state that the arbitration clause means that disputes will not be decided by a court or jury.

Tip No. 8. Draft a state-of-the-art "delegation" of authority clause. The so-called "delegation" clause—which delegates authority to arbitrators to decide certain issues—has been the subject of considerable litigation recently. Certain disputes regarding the scope, application, or enforceability of an arbitration clause or the class action waiver itself can be decided by a court instead of an arbitrator.
A review of cases over the past six months indicates that plaintiffs' class action lawyers are becoming more creative in their efforts to try to circumvent arbitration agreements with class action waivers. Oftentimes, the arbitration provisions were drafted several years ago and are no longer state-of-the-art.

Tip No. 9. Ensure your arbitration provisions are up to date, taking into account the newest legal developments in this area of the law.
In other words, don't rest on arbitration agreements drafted years ago. A lot has changed, and likely will continue to evolve, in this specialized legal field. Businesses need to continually keep tabs on new case developments, and modify their arbitration agreements to avoid legal pitfalls that could result in a class action remaining in court.

Tip No. 10. Try to keep abreast of new laws affecting arbitration of wage and hour disputes. For example, one or more state legislatures have proposed bills similar to California's Private Attorneys General Act (PAGA), which has been held to be immune from arbitration agreements.

There are dozens of other tips involved in the drafting of arbitration clauses with a class and collective action waiver. But, following the ten tips above will dramatically improve the enforceability and effectiveness of such provisions in independent contractor agreements—as well as freestanding arbitration agreements in the employment context.

One Final Key Takeaway

Arbitration agreements with class and collective action waivers are not a panacea for companies that use independent contractors. Such clauses can only protect against a claim being asserted as a class or collective action (assuming the arbitration agreement is properly drafted). They don't provide a defense on the merits of a claim that workers were improperly classified as independent contractors and are allegedly owed overtime, minimum wages, employee benefits, expense reimbursements, or other workplace benefits available to employees.

In addition, arbitration agreements with class action waivers are not binding on governmental regulators; therefore, they are wholly ineffective at forestalling federal and state regulatory agencies from conducting audits or initiating and maintaining enforcement proceedings under employment and independent contractor laws. Therefore, the importance of enhancing compliance with employment and independent contractor laws and not relying simply on an arbitration clause with a class action waiver cannot be overstated.

A growing number of companies have sought to enhance their compliance with independent contractor laws through a process such as IC Diagnostics™. This type of process evaluates a company's level of compliance and, to the extent feasible, restructures, re-documents, and re-implements the independent contractor relationship, without altering the business model—all in an effort to minimize independent contractor misclassification exposure by means of a customizable and sustainable solution.

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