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TURNING THE TABLES: USING PUBLIC POLICY *AGAINST* ARBITRATION

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Countless published cases invoke California's public policy in favor of arbitration to justify everything from expansive interpretation of arbitration agreements to the extremely narrow scope of judicial review of arbitration awards. Less well-known are two doctrines that allow parties to use public policy against arbitration, either to avoid arbitration altogether or to empower courts to review awards for errors of fact or law.

These twin public-policy doctrines are powerful tools to escape arbitration's grip. But each doctrine is governed by its own set of rules, and each is so rarely addressed in published opinions that it is easy for counsel and courts to get tripped up. This is all the more true because different rules apply depending on whether the California Arbitration Act or the Federal Arbitration Act governs the analysis. In fact, just a couple of years ago, the California Supreme Court again clarified the distinction between the two doctrines—a distinction that the Court had made plain in the early 1990s. (*Sheppard, Mullin, Richter & Hampton, LLP v. J-M Manufacturing Co., Inc*. (2018) 6 Cal.5th 59, 73-80 (*Sheppard Mullin*).)

Arbitration Awards That Violate Legislative Expressions of Public Policy.

The first doctrine is known as the "public policy exception" to the general rule of limited judicial review of arbitration awards. *Moncharsh v. Heily & Blase* (1992) 3 Cal.4th 1 (*Moncharsh*) held that awards are generally not reviewable for errors of fact or law, but also recognized that "there may be some limited and exceptional circumstances" justifying judicial review, such as when "granting finality to the arbitrator's decision would be inconsistent with the protection of a party's *statutory* rights" or a "clear" and "*explicit* legislative expression of public policy." (*Id*. at p. 32, italics added.)

The requirement that the public policy be found in a legislative enactment is key. Because the Legislature has expressed a strong public policy in favor of the finality of arbitration awards, it takes a countervailing legislative expression of public policy to justify judicial review for factual and legal errors.

Cases involving public policy and statutory rights can be divided into two easily describable categories and a more debatable catch-all category:

1. The California Supreme Court has applied the exception and allowed judicial review for errors of fact or law where the arbitrator violated a statutory right or legislatively-expressed public policy that impacts the "propriety of the arbitration itself." (*SingerLewak LLP v. Gantman* (2015) 241 Cal.App.4th 610, 676-677.) For instance:

• The Supreme Court vacated an arbitration award that ordered a school district to comply with collectively bargained terms for the discharge of probationary teachers because the award conflicted with a statute (a) excluding these issues from the scope of collective bargaining and (b) giving school districts the right to discharge probationary teachers without cause or due process. The Court held that the Legislature expressed a public policy that probationary-teacher discipline "not be subject to arbitration." (*Board of Education v. Round Valley Teachers Assn.* (1996) 13 Cal.4th 269, 277.)

• *Aguilar v. Lerner* (2004) 32 Cal.4th 974, 979, 982-983 similarly applied the public policy exception in holding that the Mandatory Fee Arbitration Act conflicts with enforcement of an award that the parties agreed would be binding (although it found that the client had waived his rights under the statute).

2. The California Supreme Court has held that the public policy exception applies where granting finality to the

arbitrator's error would bar the plaintiff from receiving a hearing on the merits of an unwaivable statutory claim. In *Pearson Dental Supplies, Inc. v. Superior Court* (2010) 48 Cal.4th 665, 669, 680, the Court held that the arbitrator "clearly erred" in determining that a Fair Employment and Housing Act claim was time-barred and that public policy required a hearing on the merits. The Court characterized the arbitrator's error as affecting the "procedural framework under which the parties agreed the arbitration was to be conducted." (*Id*. at pp. 679-680.)

3. California Courts of Appeal have occasionally applied the public policy exception to cases in which the arbitrator erroneously applied the substantive law governing the claim. A few examples demonstrate both the breadth of this catch-all category of cases and the robustness of judicial review to protect express legislative public policies:

• In *Ahdout v. Hekmatjah* (2013) 213 Cal.App.4th 21, 28, arbitrators found that the defendant had not acted as a general contractor and therefore was not required to disgorge profits under California's contractor licensing statutes. Rather than deferring to the arbitral determination, the Court of Appeal held that the trial court must "independently consider" the issue to vindicate the licensing law's public policy of protecting the public from incompetent and dishonest contractors and discouraging unlicensed contractors from charging for their services. (*Id.* at pp. 39-40.) The appellate court directed the trial court to make its de novo determination based on " 'all of the admissible evidence submitted to [the court] regardless of whether that evidence was before the arbitrator.' " (*Ibid.*)

• In *Brown v.TGS Management Company, LLC* (2020) 57 Cal.App.5th 303, the Court of Appeal vacated an award denying a declaratory relief claim that presented a facial challenge to an employment agreement's confidentiality provision. The court held that the provision was so broad that it violated the public policy—expressed in Business and Professions Code section 16600—against restraints on competition. (*Id.* at p. 307.) In considering that legal issue de novo, the Court of Appeal rejected the arbitrator's alternative conclusions that the claim was (1) nonjusticiable as unripe and (2) barred by the unclean hands defense. (*Id.* at pp. 313-319.)

• The Court of Appeal took a somewhat more deferential approach in *City of Palo Alto v. Service Employees Internat. Union* (1999) 77 Cal.App.4th 327 (*City of Palo Alto*). The court recognized that various statutes, taken together, express a public policy requiring employers to take reasonable steps to provide a safe workplace. (*Id.* at pp. 334-337.) However, the court also acknowledged that that public policy is not so broad as to prohibit reinstatement when an employee makes a threat that he does not actually intend to carry out. (*Id.* at p. 337.) Deferring to the arbitrator's conclusion that the employee did not pose an actual risk, the court thus refused to vacate the award. (*Id.* at pp. 337-338.) The court explained that a "different result might well obtain if the arbitrator had found, or there was uncontroverted evidence" that the employee's threats were genuine "or if the arbitrator failed to reach that substantive question." (*Ibid.*)

Courts will vacate an arbitration award that reinstates an employee if reinstatement necessarily entails violation of an existing court injunction that bars the employee from the workplace. (*City of Palo Alto, supra,* 77 Cal.App.4th at pp. 338-340.) This is because California's contempt laws constitute a clear legislative expression of public policy in favor of obedience to court orders. (*Ibid.*)

In an arbitration against a state entity, the arbitrator awarded the plaintiff attorney's fees in such high amounts that the court deemed the award to be an "'[in]appropriate'" gift of public funds, thus violating the public policy against such gifts as expressed in the California Constitution. (*Jordan v. California Dept. of Motor Vehicles* (2002) 100 Cal.App.4th 431, 452.)

Arbitration Clauses Contained In Contracts That Are Entirely Illegal For Violation Of Public Policy.

The second of California's two public policy doctrines is fundamentally different. It does not focus on errors in the arbitration *award*. Rather, it questions whether *the arbitration agreement itself* is illegal for violation of public policy. This analysis looks beyond legislative expressions of public policy and can include any applicable body of law invalidating the contract at issue.

Illegal arbitration agreements. Under California law, courts—not arbitrators—determine whether an arbitration agreement is void for violation of public policy. (See *Sheppard Mullin, supra,* 6 Cal.5th at pp. 74-77.) If the arbitration agreement is illegal and thus unenforceable, a party "may avoid arbitration altogether," and the trial court should deny a motion to compel arbitration. (*Moncharsh*, *supra*, 3 Cal.4th at p. 29.) Similarly, when the arbitration agreement is illegal and unenforceable, the arbitrator lacks the power to decide anything at all, so any award—right or wrong—must be vacated.

Entirely illegal agreements containing arbitration clauses. The same is true when an *entirely illegal* contract includes an arbitration clause, even if the arbitration clause is unobjectionable standing alone. If an otherwise enforceable arbitration clause is "contained in an [entirely] illegal contract," the arbitration agreement falls along with the rest of the

contract. (*Sheppard Mullin, supra*, 6 Cal.5th at pp. 74-76; see *Moncharsh, supra*, 3 Cal.4th at p. 29.) This issue is also reserved for the courts based on the "'evidence presented to the trial court, and any preliminary determination of legality by the arbitrator . . . should not be held to be binding upon the trial court.'" (*Sheppard Mullin*, at p. 75.)

This rule has a limited reach: Courts decide *only* challenges to the legality of the *entire* contract. If a party challenges the legality of only *a provision* of the contract, the arbitrator determines that illegality issue subject to ordinary rules for judicial review of arbitration awards. (*Sheppard Mullin, supra,* 6 Cal.5th at pp. 75-77; *Moncharsh, supra,* 3 Cal.4th at pp. 30-33.)

Scope of public policy review. When considering whether a contract is entirely illegal, the analysis goes far beyond a search for a *legislative* expression of public policy. Rather, the contract "may be found contrary to public policy even if the Legislature has not yet spoken to the issue." (*Sheppard Mullin, supra*, 6 Cal.5th at p. 73; see *id*. at pp. 77-80.) Sources of public policy rendering contracts or arbitration clauses illegal can include administrative regulations and common law. In other words, California law requires the same broad public policy analysis that courts would ordinarily employ in deciding whether a contract is void for violation of public policy outside the arbitration context—no "different, more restrictive rule" applies just because arbitrability is at issue. (*Id*. at pp. 74-75.)

For instance, in *Sheppard Mullin*, the Supreme Court held that a law firm's engagement agreement violated the public policy against undertaking a representation without disclosing an existing conflict of interest. (*Sheppard Mullin, supra*, 6 Cal.5th at pp. 80-81.) That violation went to the heart of the attorney-client relationship that was the subject of the agreement and thus, rendered the agreement entirely illegal. (*Id.* at pp. 86-87.) The law firm argued that this did not suffice to vacate the arbitration award because the public policy was expressed in the Rules of Professional Conduct—not any legislative expression of public policy. (*Id.* at p. 73.) The Court rejected that argument, explaining that the limitations on the "public policy exception" do not apply when courts consider the more fundamental arbitrability question about the entire illegality of the contract that contains the arbitration clause. (*Id.* at pp. 77-79.)

The Federal Approach.

Critical differences, however, apply when the case is governed by federal arbitration law.

The Public Policy Exception. Like California law, federal law recognizes that an award exceeds the arbitrator's powers if it violates " 'explicit,' 'well defined,' and 'dominant' " public policies. (*Eastern Associated Coal Corp. v. United Mine Workers of America, Dist. 17* (2000) 531 U.S. 57, 62-63 [121 S.Ct. 462, 148 L.Ed.2d 354].) But it need not be a legislative expression of public policy. Instead, federal law requires that the public policy be ascertained by reference to "positive law," which includes not just statutes, but also regulations, codes, and judicial decisions that interpret those enacted laws. (*Ibid*.; see *Southern Regional Council of Carpenters v. Drywall Dynamics, Inc.* (9th Cir. 2016) 823 F.3d 524, 534, fn. 2; *Virginia Mason Hosp. v. Washington State Nurses Ass'n* (9th Cir. 2007) 511 F.3d 908, 916-917 [analyzing asserted conflict with public policy found in state and federal regulations].) This still confines the possible sources of public policy warranting heightened judicial review of arbitration awards; courts cannot look to "general considerations of supposed public interests." (*Eastern Associated Coal Corp.,* at p. 63.) But it is broader than California's public policy exception.

Entire Contract Illegality. Under federal law, the only threshold issue the court is allowed to decide in lieu of the arbitrator is a public-policy challenge specifically to the legality of the *arbitration clause* itself—not to the agreement as a whole. (*Rent-A-Center, West, Inc. v. Jackson* (2010) 561 U.S. 63, 70-71 [130 S.Ct. 2772, 2778, 177 L.Ed.2d 403].) Unlike California law, the Federal Arbitration Act treats public-policy challenges to the entire agreement containing an arbitration clause as a question for the arbitrator. (E.g., *Phillips v. Sprint PCS* (2012) 209 Cal.App.4th 758, 774 [applying federal law]; see *Sheppard Mullin, supra*, 6 Cal.5th at pp. 71, 72, fn. 2 [California law is "unlike federal law" in this regard; case involved only application of California law].) In that circumstance, the court (either a federal court or a California court) merely severs and enforces the arbitration clause and sends the illegality dispute regarding the entire contract to the arbitrator. The consequence: Like any other arbitral determination of an arbitrable issue, under federal law the arbitrator's determination is not ordinarily reviewable for errors of fact or law.

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