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A DIALOGUE ON A CONTEMPORARY ISSUE: THE HOOTERS' CASE

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Editor

This entry in this issue of *JIER* is the first of what I hope will be a continuing feature of the journal. *JIER* is concerned with significant, contemporary issues bearing upon individual employment rights. I want to stimulate a discussion of such issues with outside experts and with the *Journal*'s readers. My vehicle for doing so in this issue is a court decision.

In the following pages is a lengthy extract from a case decided in 1999 by the Fourth Circuit Court of Appeals. I ask our readers to review this case and send me a one- to three-page analysis of the decision for possible publication in the *Journal.* I am looking for your thoughts on the issues raised in the case, your opinions about the decision and the reasoning, and your ideas about the implications of the case.

Because this issue of *JIER* is concerned with sexual harassment, the case deals with that topic and with the enforceability of a predispute agreement to arbitrate sexual harassment and, by implication, other statutory issues. The case involves a hostess in a restaurant who was pinched and patted by her supervisor, complained, and quit when the company did nothing to rectify the situation. When she threatened to sue, the firm insisted on the enforcement of an agreement to arbitrate all such disputes.

In the literature that deals with the arbitration of labor and employment disputes, one can find literally hundreds of articles on the arbitration of disputes that involve public policy or statutory issues. I ask that your analyses focus on the organizational, managerial, human, and ethical issues involved rather than on the technical and legal issues associated with predispute agreements to arbitrate.

Please send your replies to:

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FROM *HOOTERS OF AMERICA, INCORPORATED v. ANNETTE R. PHILLIPS* 173 F. 3d 933 (4th Cir. 1999)

Editor's Note: This is not a word-for-word replication of the decision made by the Fourth Circuit Court of Appeals in the case captioned above. The material that follows has been taken directly from the court's opinion, but the text has been streamlined and rewritten for a more general audience. Most names have been eliminated, as have all footnotes, except those that are tied into a direct quote. Material the editor considered extraneous has been reduced or eliminated, and bridging sections have been added to provide continuity. The bridging sections are noted and in italics.

Background

Ms. Phillips worked as a bartender at a Hooters restaurant in Myrtle Beach, South Carolina. She alleges that in June 1996, a Hooters official and the brother of the organization's principal owner sexually harassed her by grabbing and slapping her buttocks. After appealing to her manager for help and being told to "let it go," she quit her job. Phillips then contacted Hooters through an attorney, claiming that the attack and the restaurant's failure to address it violated her rights under Title VII of the Civil Rights Act of 1964.

Hooters responded by saying that she was required to submit her claims to arbitration according to a binding agreement to arbitrate disputes between the parties that arose out of employment. This agreement arose in 1994 during the implementation of Hooters' alternative dispute resolution program. As part of that program, the company conditioned eligibility for raises, transfers, and promotions upon an employee's signing an agreement to arbitrate employment-related disputes. The agreement provides that Hooters and the employee agree to arbitrate all disputes arising out of employment, including any claim of discrimination, sexual harassment, retaliation, or wrongful discharge, arising under federal or state law.

The employees were initially given a copy of this agreement at an all-staff meeting held on November 20, 1994. The general manager gave the employees five days to review the agreement and told them they would then be asked to accept or reject it. The employees were given a copy of Hooters' arbitration rules and procedures. Phillips signed the agreement on November 25, 1994. When her personnel file was updated in April 1995, she signed it again.

After she quit her job in June 1996, Phillips refused to arbitrate the dispute, and, in November 1996, Hooters filed suit in the federal district court to compel arbitration. Phillips defended on the grounds that the agreement to arbitrate was unenforceable, and she also asserted individual and class counterclaims against Hooters for violations of Title VII of the Civil Rights Act of 1964. In response, Hooters requested that the district court stay the proceedings.

In March 1998, the district court denied Hooters' motions [1]. In an extensive opinion, the court found there had been no meeting of the minds on the material terms of the agreement and even if there had been, Hooters' promise to arbitrate was illusory. In addition, the court found that the arbitration agreement was unconscionable and void for reasons of public policy. Hooters appealed.

The Court Discusses the Benefits of Arbitration

The 4th Circuit Court of Appeals noted that the benefits of arbitration are widely recognized. Parties agree to arbitrate to secure streamlined proceedings and expeditious results that will best serve their needs. The arbitration of disputes enables parties to avoid the costs associated with pursuing a judicial resolution of their grievances (this court estimated those costs at $50,000 and estimated that such cases took two and one-half years to resolve). Further, the court suggested that the adversarial nature of litigation diminishes the possibility that the parties will be able to salvage their relationship. For these reasons parties agree to arbitrate and trade the procedures and opportunity for review of the courtroom for the simplicity, informality, and expedition of arbitration [2].

In support of arbitration, Congress passed the Federal Arbitration Act (FAA) in 1925. "Its purpose was to reverse the longstanding judicial hostility to arbitration agreements that had existed at English common law and had been adopted by American courts, and to place arbitration agreements upon the same footing as other contracts" [2, at 24]. When a valid agreement to arbitrate exists between the parties and covers the matter in dispute, the FAA commands the federal courts to stay any ongoing judicial proceedings and to compel arbitration.

The Threshold Question

The threshold question is whether claims such as Phillips' are even arbitrable. The Supreme Court has made it plain that judicial protection of arbitral agreements extends to agreements to arbitrate statutory discrimination claims. In *Gilmer,* the Court noted that by "agreeing to arbitrate a statutory claim, a party does not forgo the substantive rights afforded by the statute; it only submits to their resolution in an arbitral, rather than a judicial forum" [2, at 26]. Thus, a party must be held to the terms of its bargain unless Congress intends to preclude waiver of a judicial forum for the statutory claims at issue. Such an intent, however, must "be discoverable in the text of the [substantive statute], its legislative history, or an 'inherent conflict' between arbitration and the [statute's] underlying purposes" [2, at 26].

> *[After reviewing case law on the validity of predispute agreements to arbitrate, the court concluded that predispute agreements to arbitrate Title VII claims were both valid and enforceable. Then it turned to the question of whether binding arbitration agreement existed between Phillips and Hooters that would compel Phillips to submit her Title VII claims to arbitration.]*

The FAA provides that agreements to settle controversies over contracts and other transactions by arbitration are valid, irrevocable, and enforceable, unless grounds exist at law or in equity for the revocation of any contract. It is also commonly held that it is for the court, not the arbitrator, to decide whether the dispute is to be resolved through arbitration and that the court's review is to be limited to ensuring that a valid agreement to arbitrate exists between the parties and the dispute falls within the substantive scope of that agreement.

Hooters argued that Phillips gave her assent to a bilateral agreement to arbitrate. That contract provided for the resolution by arbitration of all employment-related disputes, including claims arising under Title VII. Hooters claimed the agreement to arbitrate was valid because Phillips twice signed it voluntarily and, therefore, the courts are bound to enforce it and compel arbitration.

The court disagreed, holding that the judicial inquiry is not focused solely on an examination for contractual formation defects such as lack of mutual assent and want of consideration. Courts can investigate the existence of "such grounds as exist at law or in equity for the revocation of any contract" [3]. However, the grounds for revocation must relate specifically to the arbitration clause and not just to the contract as a whole.

In this case, the challenge goes to the validity of the arbitration agreement itself. Hooters materially breached the arbitration agreement by promulgating rules so egregiously unfair as to constitute a complete default of its contractual obligation to draft arbitration rules and to do so in good faith. Hooters and Phillips agreed to settle any disputes between them not in a judicial forum, but in another neutral forum—arbitration. Their agreement provided that Hooters was responsible for setting up such a forum by promulgating arbitration rules and procedures. To this end, Hooters instituted a set of rules in July 1996.

The Hooters' rules, however, were so one-sided that their only possible purpose is to undermine the neutrality of the proceeding. The rules require the employee to provide the company notice of her claim at the outset and the specific act(s) or omissions(s) that are the basis of the claim. But Hooters is not required to file any responsive pleadings or to notice its defenses. Additionally, at the time of filing this notice, the employee must provide the company with a list of witnesses and a brief summary of the facts known to each. The company, however, is not required to reciprocate.

The Hooter's rules also provide a mechanism for selecting a panel of three arbitrators that is crafted to ensure a biased decision maker. Under one of the company's rules, the employee and Hooters each select an arbitrator, and the two arbitrators in turn select a third. On the surface, this rule appears to be fine, except that the employee's arbitrator and the third arbitrator must be selected from a list of arbitrators created exclusively by Hooters. This gives Hooters control over the entire panel and places no limits whatsoever on whom Hooters can put on the list. Under the rules, Hooters is free to devise lists of partial arbitrators who have existing relationships, financial or familial, with Hooters and its management. In

fact, the rules do not even prohibit Hooters from placing its managers on the list. Further, nothing in the rules restricts Hooters from punishing arbitrators who rule against the company by removing them from the list. Given the unrestricted control that Hooters has over the panel, the selection of an impartial decision maker would be a surprising result.

The court then said that fairness was not to be found once the proceedings were begun. The rules permitted Hooters to expand the scope of arbitration to any matter, "whether related or not to the employee's claim," but the employee was not allowed to raise "any matter not included in the Notice of Claim" [4]. Similarly, Hooters was permitted to move for summary dismissal of employee claims before a hearing was held, whereas the employee was not permitted to seek summary judgment. Further, Hooters, but not the employee, could record the arbitration hearing by taping or by transcription, and the employer, but not the employee, has the right to bring suit in court to vacate or modify an arbitral award on a claim that the panel exceeded its authority. In addition, the rules provided that Hooters, but not the employee, might cancel the agreement to arbitrate or modify the rules without notice to the employee. Nothing in the rules even prohibited Hooters from changing the rules during an arbitration proceeding.

The court noted that leading arbitration experts have decried the one-sidedness of these rules. It quoted the testimony of George Friedman, senior vice president of the American Arbitration Association (AAA), who testified that the system established by the Hooters' rules so deviated from minimum due process standards that the association would refuse to arbitrate under those rules. It also quoted George Nicolau, former president of both the National Academy of Arbitrators and the International Society of Professionals in Dispute Resolution, who attested that the Hooters' rules were inconsistent with the concept of fair and impartial arbitration. The court quoted Dennis Nolan, professor of labor law at the University of South Carolina, who declared that the Hooters' rules did not satisfy the minimum requirements of a fair arbitration system, particularly in that the mechanism for selecting arbitrators violated the most fundamental aspect of justice, namely an impartial decision maker. Finally, Lewis Maltby, member of the board of directors of the, AAA, was quoted as testifying that the Hooters' system was the most unfair arbitration program he had ever encountered.

The court noted further that two major arbitration associations had filed amicus briefs. The National Academy of Arbitrators criticized the Hooters' rules for violating fundamental concepts of fairness and integrity. The Society of Professionals in Dispute Resolution concluded that it would be difficult to imagine a more unfair method of selecting a panel of arbitrators.

The Decision of the Court

The Fourth Circuit Court of Appeals held that the promulgation of so many biased rules breaches the contract entered into by the parties, especially the scheme

whereby one party so controls the arbitral panel. The parties agreed to submit their claims to arbitration, but Hooters had established a sham system unworthy to be called arbitration.
[At this point there was a discussion of good faith requirements in relation to the Second Restatement of Torts.]

By agreeing to settle disputes in arbitration, Ms. Phillips should have been able to legitimately expect that arbitration would not entail procedures so wholly one-sided as to present a stacked deck. Thus the court concluded that the Hooters' rules violated the contractual obligation of good faith.

Given Hooters' breaches of the arbitration agreement and Phillips' desire not to be bound by it, the court held that rescission is the proper remedy. *[At this point there was a discussion of the concept of recission.]* Hooters' breach was by no means insubstantial; its performance under the contract was so egregious that the result was hardly recognizable as arbitration at all. The court, therefore, permitted Phillips to cancel the agreement and ruled that Hooters' suit to compel arbitration must fail.

Limits to the Reach of the Decision

[At this point the court discussed some of the things that the decision did not do.] The court indicated:

1. That it did not hold that the arbitration agreement was unenforceable because the arbitral proceedings were too abbreviated. The opinion stated that an arbitral forum need not replicate the judicial forum.
2. That it did not want its decision to encourage a full-scale assault on the fairness of proceedings before a matter is submitted to arbitration. Generally, objections to the nature of arbitral proceedings are for the arbitrator to decide in the first instance. Only *after* arbitration may a party then raise such challenges if they meet the narrow grounds set out in the Federal Arbitration Act for vacating an arbitral award. The court then went on to state that the Hooters' case was the exception that proves the rule.
3. The court dealt with Ms. Phillips' assertion that the Hooters' rules also attempt to effect a waiver of substantive statutory rights by limiting the remedies that an arbitration panel may award. She argued that employees cannot waive substantive statutory rights in predispute arbitration agreements, or that such waivers must be knowing and voluntary. The Hooters' court concluded that because no valid agreement to arbitrate existed, it need not take up these questions [5].

The Holding

The court held that the Hooters' system of warped rules so skewed the arbitration process in its favor that Phillips was denied arbitration in any meaningful

sense of the word. The court affirmed the judgment of the district court, and remanded the case for further proceedings consistent with this opinion.

ENDNOTES

1. *Annette R. Phillips v. Hooters,* 76 FEP Cases 1757 (S.D.S.C. 1998).
2. *Gilmer v. Interstate Johnson Lane,* 500 U.S. 20 (1991).
3. 9 U.S.C. § 2.
4. Hooters, Inc., *Rules of Arbitration,* Rules 4-2, 8-9.
5. The Fourth Circuit did address this question in *Wright v. Universal Maritime Corporation,* where it compelled an employee covered by a collective bargaining agreement to arbitrate his case, even though the matter involved the Americans With Disabilities Act. The Supreme Court reversed this decision, stating that any waiver of statutory rights must be "clear and unmistakable" [525 U.S. 70 (1998)].

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