# Arb. Agreement Case Is A Warning On Employee Handbooks

By **David Dubberly and Brittany Clark** (July 14, 2022)

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Arbitration agreements are a valuable protection for companies to keep legal claims by employees out of the courts, but they are not necessarily routinely enforced.

On April 25, the U.S. Court of Appeals for the Fourth Circuit in Coady v. Nationwide Motor Sales Corp. held that an arbitration agreement presented to employees as part of an employee handbook, and not as a separately signed contract, was not enforceable.[1]

The Fourth Circuit found that the acknowledgment of receipt of the employee handbook, which stated the employer retained the right to unilaterally change or modify the handbook's provisions, applied to the arbitration agreement, rendering the agreement "illusory, and thus invalid."

The decision serves as a warning to employers regarding potential issues with the enforceability of arbitration agreements with their employees, which are generally construed according to state contract law.

As demonstrated by Coady, arbitration agreements may be particularly vulnerable when included as part of an employee handbook that the employer has unilateral authority to modify.

The case arose when former employees of Nationwide Motor Sales brought suit in federal court alleging the company and its owners had engaged in fraudulent payment practices that reduced their sales commissions and final paychecks.

Nationwide moved to compel arbitration and to dismiss or stay the proceedings filed by the employees because the employees had signed for receipt of the employee handbook, which contained a section titled "Agreement to Submit All Employment Disputes to Arbitration."

The arbitration agreement set out in the employee handbook stated an intention to arbitrate employment-related claims and specified the rules and procedures that would apply to such a proceeding.

It also referenced that the employees acknowledged the receipt of the handbook, which itself referenced the arbitration agreement and stated that Nationwide had "the right, from time to time, to … change, abolish or modify existing policies, procedures and benefits applicable to employees as it may deem necessary with or without notice."

In opposing Nationwide's motion to compel arbitration, the employees argued that the arbitration agreement was invalid and unenforceable. They asserted the agreement was an illusory promise because Nationwide retained the right to change, abolish or modify the handbook, which included the arbitration agreement.

In reply, Nationwide countered that the modification clause did not apply to the arbitration agreement because it was not included within the four corners of the agreement. In other words, because the modification clause was not part of the arbitration agreement itself but

rather was incorporated in the handbook acknowledgment, Nationwide asserted that it did not retain the right to modify the arbitration agreement.

Nationwide further argued that the plain language of the modification clause demonstrated that it did not apply to the arbitration agreement as the clause refers only to policies, procedures and benefits set out in the handbook, but not to agreements.

The U.S. District Court for the District of Maryland denied Nationwide's motion to compel arbitration of the employment dispute, agreeing with the employees that the arbitration agreement was illusory due to the modification clause. Nationwide then filed an interlocutory appeal with the Fourth Circuit.

The Fourth Circuit analyzed the issue as a matter of contract interpretation, applying Maryland law. The court stated:

> Arbitration is a matter of contract. Before we may enforce the Arbitration Agreement, we must be satisfied that a valid agreement exists. The presumption favoring arbitration does not apply to this preliminary question of the Arbitration Agreement's validity. We resolve this question according to the state-law principles of contract formation and interpretation.[2]

The Fourth Circuit found that the acknowledgement of receipt was part of the arbitration agreement. The court noted that the arbitration agreement referenced the acknowledgement of receipt and that the acknowledgment of receipt also referenced the arbitration agreement.

The Fourth Circuit then considered whether the modification clause of the handbook acknowledgement rendered the arbitration agreement invalid. Under Maryland law, a promise to arbitrate is illusory — and thus cannot constitute the consideration necessary to support a binding contract — if the employer reserves the right "to alter, amend, modify, or revoke the [arbitration agreement] at any time with or without notice."

The Fourth Circuit reviewed and analyzed the wording of the acknowledgement as a whole.

Because the acknowledgement form contained the modification language and stated that it applied to the handbook as a whole without exception, the court found that the modification language must also apply to the arbitration agreement, rendering the agreement illusory and unenforceable under Maryland contract law.

This case serves as a warning to employers because arbitration agreements are frequently included in employee handbooks or similar documents, many of which provide that the employer can unilaterally modify their terms. Such a modification clause may render an agreement unenforceable in certain circumstances, like that involving arbitration under Maryland contract law.

Importantly, even in federal court, issues surrounding the validity and enforceability of contracts, including arbitration agreements, are generally governed by state law.

Moreover, as the Fourth Circuit stated in Coady, the presumption favoring arbitration — as set out in the Federal Arbitration Act, or FAA — does not apply to the preliminary question of whether an arbitration agreement is valid under state law contract principles, which require an offer, acceptance and consideration.

The Supreme Court's recent decisions in Morgan v. Sundance Inc. in May[3] and Southwest Airlines Co. v. Saxon in June[4] further suggest that employers should carefully review and consider the enforceability of their arbitration agreements with employees. Although the FAA includes a policy favoring arbitration, that policy is not without its limits as demonstrated in both Morgan and Saxon.

In Morgan, the court held that federal courts may not adopt an arbitration-specific procedural rule conditioning a waiver of the right to arbitrate on a showing of prejudice. And in Saxon, the court found that airplane cargo loaders and ramp supervisors are exempt from the FAA's coverage because those types of workers belong to a "class of workers engaged in foreign or interstate commerce."

Thus, even though the FAA and courts generally favor arbitration, this is only true when a valid and enforceable arbitration agreement exists between the parties. Courts must still evaluate the validity of an agreement to arbitrate under the traditional rules of contract law and interpretation before compelling arbitration of a dispute.

With all of this in mind, employers should review their arbitration agreements, as well as other contracts or agreements with employees, to ensure the agreements are valid and enforceable contracts under the applicable state or jurisdiction's law.

Employees cannot be compelled to arbitrate claims unless they have contractually agreed to be bound by arbitration in compliance with the relevant state law.

Employers stand a better chance of enforcing arbitration agreements that are set out in a separately signed document that is clear and definite and does not contain other policies and disclaimers like those found in employee handbooks.

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[1] Coady v. Nationwide Motor Sales Corp. , 32 F.4th 288 (4th Cir. 2022).

[2] Coady, 32 F.4th at 290 (citations omitted).

[3] Morgan v. Sundance, Inc. , 142 S. Ct. 1708 (2022).

[4] Sw. Airlines Co. v. Saxon , 142 S. Ct. 1783 (2022).