WHETHER AN AGREEMENT TO ARBITRATE DISPUTES IS ILLUSORY AND THUS UNENFORCEABLE WHEN ONE PARTY HAS THE POWER TO TERMINATE ITS OBLIGATION AT ANY TIME, EFFECTIVE IMMEDIATELY WITHOUT ADVANCE NOTICE OF TERMINATION

By Amy Hedgecock*

Nelson v. Watch House Int'l, L.L.C., 815 F.3d 190 (5th Cir. 2016).

Michael Nelson ("Nelson") filed a lawsuit in federal court alleging he was terminated by his employer, Watch House International, L.L.C. ("Watch House"), in violation of Title VII of the Civil Rights Act of 1964 and Chapter 21 of the Texas Labor Code.[1] Watch House sought to enforce an arbitration provision within the employee handbook. However, because the "Arbitration Plan" provided Watch House could make unilateral changes to the plan without advance notice to employees, the Fifth Circuit held the arbitration provision was illusory and Nelson could not be forced to arbitrate his claims.[2]

Upon receiving an offer of employment, Nelson received a copy of the Employee Handbook which contained an "Arbitration Plan" (the "Plan"),[3] pursuant to which the employer and employee agreed to arbitrate any and all claims.[4] The parts of the Plan that are at issue are as follows: "the procedures, practices, policies and benefits described here may be modified or discontinued from time to time;" and "the Company reserves the right to . . . revoke . . . at any time with or without notice."[5] Any alteration by the employer would be "immediately effective upon notice to Applicant/Employee of its terms, regardless of whether it is signed by either Agreeing Party."[6] After having worked for the company for four years, Nelson claimed that he was terminated shortly after advising his supervisor of continued religious and racial harassment by his coworkers.[7] Nelson filed suit in the United States District Court for the Northern District of Texas and Watch House moved to compel arbitration.[8] The District Court granted the motion to compel arbitration and dismissed Nelson's claims.[9] Nelson appealed on the grounds that "the Arbitration Plan is illusory because it fails to include a savings clause related to existing claims and disputes requiring advance notice of termination; . . . [and] that Nelson does not fall within the Plan's definition of 'employee' and so is not bound to arbitrate."[10]

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* Amy Hedgecock is a 2017 J.D. Candidate at South Texas College of Law Houston.

1 Nelson v. Watch House Int'l, L.L.C., 815 F.3d 190, 192 (5th Cir. 2016).

2 *Id.* at 195–96.

3 *Id.* at 191.

4 *Id.*

5 *Id.* at 192 n.2.

6 *Id.* at 191–92.

7 *Id.* at 192.

8 *Id.*

9 *Id.*

10 *Id.*

THE LAW

The parties agreed that Texas law governed,[11] and in Texas an arbitration agreement, like other contracts, "must be supported by consideration."[12] If one party can "avoid its promise to arbitrate by amending the provision or terminating it all together," an arbitration clause is considered illusory in Texas.[13] In other words, if one party has "unrestrained unilateral authority" to alter or even terminate the obligation altogether, the agreement will be found to be illusory.[14] The Fifth Circuit has determined that there is a two-step analysis to determine whether the parties agreed to arbitration: first, did the parties intend to arbitrate; and second, whether this particular claim is contained within the arbitration agreement.[15]

The landmark Texas case regarding an arbitration clause being illusory is *In re Halliburton Co.*[16] In *Halliburton*, the Texas Supreme Court focused on two fundamental provisions: (1) the agreement provided that "no amendment shall apply to a Dispute of which . . . [employer] had actual notice on the date of amendment," and (2) that the "termination shall not be effective until 10 days after reasonable notice of termination is given to Employees or as to Disputes which arose prior to the date of termination."[17] These two provisions constituted a "savings clause" that prevented the employer from "avoid[ing] its promise to arbitrate by amending or terminating [the arbitration agreement] altogether."[18] The Supreme Court further explained in *In re 24R, Inc.*, that when a "savings clause" forces an employer to act upon its promise (rather than being able to avoid the promise), the arbitration agreement is not illusory.[19]

THE TEST

The Court has created a "simple, three-prong test to determine whether a *Halliburton*-type savings clause sufficiently restrains an employer's unilateral right to terminate its obligation to arbitrate."[20] An agreement will not be illusory so long as the retained termination power "(1) extends only to prospective claims, (2) applies equally to both the employer's and the employee's claims, and (3) so long as advance notice to the employee is required before the termination is effective."[21] The key is that the provision must include both, prospective claims and advance notice.[22]

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[11] *Id.* at 193.

[12] *Id.* (quoting Lizalde v. Vista Quality Markets, 746 F.3d 222, 225 (5th Cir. 2014), which in turn quoted Mendivil v. Zanios Foods, Inc., 357 S.W.3d 827, 831 (Tex. App.—El Paso 2012, no pet.)).

[13] *Nelson*, 815 F.3d at 193 (citing Carey v. 24 Hour Fitness, USA, Inc., 669 F.3d 202, 205 (5th Cir.2012), which in turn quoted *In re* 24R, Inc., 324 S.W.3d 564, 567 (Tex. 2010)).

[14] *Nelson*, 815 F.3d at 193 (quoting *Lizalde*, 746 F.3d at 225).

[15] *Nelson*, 815 F.3d at 192–93 (citing *Carey*, 669 F.3d at 205).

[16] *In re* Halliburton Co., 80 S.W.3d 566 (Tex. 2002).

[17] *Id.* at 569–70.

[18] *Nelson*, 815 F.3d at 193 (citing *Carey*, 669 F.3d at 206, which in turn quoted *Halliburton*, 80 S.W.3d at 570)).

[19] *Nelson*, 815 F.3d at 193 (citing *In re* 24R, Inc., 324 S.W.3d 564, 567 (Tex. 2010), which in turn cited *Halliburton*, 80 S.W.3d at 570).

[20] *Nelson*, 815 F.3d at 193–94.

[21] *Id.* (citing *Halliburton*, 80 S.W.3d at 569–70).

[22] *Nelson*, 815 F.3d at 194.

In this case, the Court found that the plan did apply equally to both parties.[23] However, because Watch House could unilaterally make changes to the plan, and there was no *Halliburton*-type savings clause which required advance notice of termination, the arbitration agreement failed the last prong of the *Lizalde* test and was deemed illusory.[24] Because the plan was illusory, the Court held that Nelson was not bound and could not be compelled to arbitrate.[25]

[23] *Id.* at 195.

[24] *Id.*

[25] *Id.* at 196.