

## FRANCHISE DISPATCH

### Enforceability of Arbitration Clauses Affected by Recent Cases

Several recent cases have enmeshed the enforcement of arbitration clauses in franchise agreements in an array of court-made rules. The Federal Arbitration Act ("FAA") was passed to prevent impediments to the enforcement of arbitration agreements. In theory, such agreements will be enforced as written, unless, as provided in Section 2 of the FAA, they are found to be invalid "upon such grounds as exist at law or in equity for the revocation of any contract." The FAA has been the subject of several opinions from the U.S. Supreme Court and forms the underpinning of the federal preemption doctrine. In its simplest terms, the federal preemption doctrine states that agreements to arbitrate will be enforced as written, and attempts to restrict them by legislation or judicial decision will not be allowed. See Miller and Hart, "The FAA on a Collision Course with the Unconscionability Doctrine," *Franchise Law Journal*, Summer 2001 (a copy of this article can be found on our web site at [www.bztm.com](http://www.bztm.com) under the "Franchise and Distribution" practice area section).

On December, 28, 2001, the Ninth Circuit Court of Appeals handed down *Bradley v. Harris Research, Inc.*, 2001 WL 1658728 (9th Cir. 2001), holding that the FAA preempts *California Business & Professions Code* section 20040.5, which states that a franchise agreement provision requiring an out of state venue for a franchise-related dispute is unenforceable. Since this section applies both to litigation and to arbitration, many had thought that the FAA would not preempt its effect. However, the *Bradley* Court held that since this section is applicable only to franchise agreements and not to "any contract," it is trumped by the FAA. A similar result occurred in *Doctor's Associates, Inc. v. Casarotto*, 517 U.S. 681 (1996), when the United States Supreme Court held that the FAA preempted

Montana's requirement that the existence of an arbitration clause must be disclosed on the front page of all contracts. Does *Bradley* spell the end of disputes over the enforcement of arbitration provisions in franchise agreements? Not at all.

In September 2001, the Ninth Circuit Court of Appeals in *Ticknor v. Choice Hotels Int'l, Inc.*, 265 F.3d 931 (9th Cir. 2001), upheld the decision of a federal district court in Montana finding that an arbitration clause in a hotel franchise agreement would not be enforced since it was, in the court's view, unconscionable due to its one-sided nature and the inequality in bargaining power between the parties to the contract. Since the doctrine of unconscionability provides a defense against the enforcement of *any* contract under Montana law, the court was not confronted with the issue in *Casarotto*, a restriction aimed only at arbitration contracts. What makes *Ticknor* interesting is that the arbitration provision at issue is a fairly standard franchise agreement clause that provides that the franchisor can take some issues directly to court while requiring the franchisee to bring an arbitration action, often only in the franchisor's home state, on all of its complaints. In *Ticknor*, the franchisor reserved its right to use the court system for certain claims, such as the right to litigate claims for indemnity—claims which usually arise in the context of third party claims already in litigation, trademark enforcement—which often involves a federal court injunction, and actions for the collection of moneys owed to the franchisor under the contract—something that would be appropriate for arbitration; perhaps the key provision in this case.

Unconscionability is usually found where there are shockingly one-sided provisions in a contract that one party is forced to accept because of some leverage possessed by the other party, a so-called "adhesion contract." The concern caused by recent cases is that what courts find to constitute adhesion contracts and what they determine to be unconscionable seems to be expanding and is often unpredictable.

In *Laxmi Investments, LLC v. Golf USA*, 193 F.3d 1095 (9th Cir. 1999), an earlier case, the Ninth Circuit was asked to determine the interplay between the FAA and the forum selection restriction found in *California Business & Professions Code* section 20040.5 (the issue decided in *Bradley*). However, instead of reaching that issue, the court found that there was no valid forum selection clause in the concerned arbitration agreement because of confusion caused by state-mandated language in the franchisor's Franchise Offering Circular questioning the enforceability of such a provision under *California Business & Professions Code* section 20040.5. Had *Bradley* been decided before *Laxmi*, settling the enforceability issue, it is possible that the result would not have been the same, assuming that the state regulators allowed the provision creating the confusion to be eliminated or qualified by the franchisor.

The *Bradley* Court was asked to decide in favor of the franchisee on the same basis as in *Laxmi*. However, the court did not address that issue because it was not properly raised on appeal. The *Bradley* Court indicated that the holding in *Laxmi*

may be avoided if the franchisor clearly indicates its intent to enforce the forum selection clause despite the language required by the state, assuming that the state regulators permit such qualifying language to appear in the circular or franchise agreement.

In light of *Bradley*, *Ticknor*, and *Laxmi*, challenges to arbitration provisions in franchise agreements will now probably rely on generally-applicable contract defenses, such as unconscionability, and on technical mutuality of obligation arguments based on the specific language of the documents in question, and no longer on *California Business & Professions Code* section 20040.5. For those who draft or seek to enforce arbitration clauses in franchise agreements, the troubling aspect of these cases is that, despite judicial discussions about the nature of adhesion contracts and unconscionability and courts' interpretation of contract and offering circular language, the ultimate enforceability of such provisions can be difficult to predict. This causes uncertainty about the ultimate outcome of such cases and provides little guidance in contract drafting and enforcement. Therefore, care must be taken by franchisors when drafting arbitration provisions to disregard the urge to make the agreements overly advantageous to one party at the expense of the other, to make the remedies available to the parties comparable, to try to abide by state-mandated language and to expect the clause to be tested by the growing body of law on unconscionability.

Bartko, Zankel, Tarrant & Miller publishes Franchise Dispatch as a service to our clients and friends. This publication is issued periodically and should be viewed only as a general summary of the law and not as a substitute for legal consultation in any particular case. If you would like to be placed on our mailing list to receive future publications, please complete the following form and return a photocopy of this page to us by fax at 415-956-1152, or e-mail gwilson@bztm.com with the information.

Name: \_\_\_\_\_  
Title: \_\_\_\_\_  
Company: \_\_\_\_\_  
Address: \_\_\_\_\_  
City/State/Zip: \_\_\_\_\_  
Telephone Number: \_\_\_\_\_ Fax Number: \_\_\_\_\_  
E-mail: \_\_\_\_\_

**BARTKOZANKEL**  
Bartko-Zankel-Tarrant-Miller

A Professional Corporation  
900 Front Street, Suite 300  
San Francisco, CA 94111  
p: 415.956.1900  
f: 415.956.1152  
www.bztm.com

**Practice Group Attorneys:**

Charles G. Miller - cmiller@bztm.com  
Darryl A. Hart - dhart@bztm.com  
C. Griffith Towle - gtowle@bztm.com  
Christopher D. Sullivan - csullivan@bztm.com