

Hot Topics in Franchise Litigation: *Recent Developments Involving the Rights, Remedies, and Alternative Dispute Resolution Procedures for California Franchisors and Franchisees*

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I. Introduction

With many significant decisions still on the horizon, 2005 has already brought many developments to the area of franchise law. While it would be possible to address numerous recent state and federal decisions with equally important implications on franchise disputes, this article attempts to limit its analysis to just a few critically important cases and recent developments involving civil procedure, arbitration agreements and their interpretation in California state and federal courts, as well as various other significant developments affecting the rights and remedies of California franchisors and franchisees.

II. Recent California Cases Affecting the Franchise Litigation

A. *Grafton Partners v. Superior Court*: California Supreme Court Unanimously Decides that Certain Pre-Dispute Jury Trial Waivers are Unconstitutional and Unenforceable

In *Grafton Partners L.P. v. Superior Court*,² the California Supreme Court addressed the enforceability of predispute contractual agreements that include jury trial

¹ I wish to acknowledge with appreciation the assistance of Scot Wilson.

waivers.³ The Court unanimously held that predispute jury trial waivers are unconstitutional and unenforceable. The case will likely have a significant outcome on many franchise disputes, but should not effect franchise arbitration agreements.

1. Factual Background

In March of 1999, the petitioners contracted with PriceWaterhouseCoopers LLP, the real party in interest, to audit certain accounts belonging to Grafton Partners' partnerships.⁴ Confirming the agreement, PriceWaterhouseCoopers sent the petitioners an engagement letter and retainer agreement that, under the heading of "Release and indemnification," provided:

'In the unlikely event that differences concerning [real party's] services or fees should arise that are not resolved by mutual agreement, to facilitate judicial resolution and save time and expense of both parties, [petitioners and real party] agree not to demand a trial by jury in any action, proceeding or counterclaim arising out of or relating to [real party's] services and fees for this engagement.'⁵

Despite the apparent jury trial waiver, on June 27, 2002, Grafton Partners filed a complaint against PriceWaterhouseCoopers in Alameda County Superior Court, alleging causes of action for negligence, misrepresentation, and a litany of other claims based on allegations that PriceWaterhouseCoopers failed to disclose and covered up certain fraudulent business practices that it discovered during its audit.⁶ After a series of demurrers and motions to strike, the Court, "relying upon the waiver contained in the engagement letter, granted [PriceWaterhouseCoopers'] motion to strike the jury demand."⁷

Based on the trial court's ruling, Grafton Partners filed a petition for writ of mandate or prohibition in the Court of Appeal.⁸ The Court of Appeal "concluded that a predispute waiver of a jury trial is not authorized by [California Code of Civil Procedure] section 631, and that only those waivers authorized by statute are consistent with article I,

² *Grafton Partners v. Superior Court*, 36 Cal. 4th 944 (Cal. 2005).

³ *Id.* at 950.

⁴ *Id.*

⁵ *Id.*

⁶ *Id.* at 950-951.

⁷ *Id.* at 951.

⁸ *Id.*

section 16 of the California Constitution.”⁹ PriceWaterhouseCoopers petitioned to the California Supreme Court for review.

2. Analysis

The *Grafton Partners* Court began its analysis by observing that, “[w]hen parties elect a judicial forum in which to resolve their civil disputes, article I, section 16 of the California Constitution accords them the right to trial by jury. . . .”¹⁰ Moreover, the Court noted that:

Our Constitution treats the historical right to a jury resolution of disputes that have been brought to a judicial forum as fundamental, providing that in ‘a civil cause,’ any waiver of the inviolate right to a jury determination must occur by consent of the party to the cause *as provided by statute*.¹¹

Section 631 of the California Code of Civil Procedure is “[t]he statute implementing this constitutional provision.”¹² Under Code of Civil Procedure section 631, “a jury may be waived in civil cases only as provided in subdivision (d) of its provisions.”¹³ Pursuant to Section 631(d), there are six (6) “means by which the right to jury trial may be forfeited or waived, including”: (1) failure to appear at trial; (2) failure to demand a jury trial within the requisite time after the case is set for trial; (3) failure to pay jury fees before or during trial; (4) oral consent in open court; or (5) written consent filed with the clerk or court.¹⁴

⁹ *Id.* (The California Supreme Court granted PriceWaterhouseCoopers’ petition for review.)

¹⁰ *Id.* The Court did, however, note that there are “limited exceptions” to the right to trial by jury, but that such exceptions were “not relevant in the present case.” *Id.*

¹¹ *Id.* (citing Cal. Const., art. I § 16) (italics in original). In pertinent part, section 16 of Article I provides that “[t]rial by jury is an inviolate right and shall be secured to all. . . . *In a civil cause a jury may be waived by the consent of the parties expressed as prescribed by statute.*” *Id.* at n. 3 (italics in original).

¹² *Id.*

¹³ *Id.* (citing Cal. Code Civ. Proc. § 631(a)).

¹⁴ *Id.*

Before *Grafton Partners*, in 1991, in *Trizec Properties, Inc. v. Superior Court*,¹⁵ the Court of Appeal considered whether a predispute jury trial waiver was enforceable and held that, although Code of Civil Procedure section 631 does not specifically authorize such waivers, predispute jury trial waivers are enforceable without statutory authorization.¹⁶ Forced to reconcile its holding with the 1991 rationale of the Court of Appeal, the *Grafton Partners* Court went to great lengths to distinguish *Trizec Properties*.¹⁷ Most notably, the Supreme Court relied on its 1855 decision in *Exline v. Smith*¹⁸ to ultimately disapprove of *Trizec*. According to the Court, under *Exline* and a long line of subsequent cases, the Court has consistently “held that the rules under which the parties to a lawsuit may waive a jury trial must be prescribed by the Legislature, which is without power to delegate to the courts the responsibility of determining the circumstances under which such a waiver may be permitted.”¹⁹

Like the Court of Appeal, the *Grafton Partners* Court was not persuaded by the *Trizec* analysis which found predispute jury trial waivers analogous to arbitration clauses.²⁰ “Unlike predispute jury waivers, predispute arbitration agreements are specifically authorized by statute.”²¹ Furthermore, the Court urged that “arbitration agreements are distinguishable from waivers of the right to jury trial in that they represent an agreement to avoid the judicial forum altogether.”²² Thus, “[t]o the extent *Trizec*

¹⁵ 229 Cal. App. 3d 1616 (Cal. Ct. App. 1991) (overruled in part by *Grafton Partners v. Superior Court*, 36 Cal. 4th 944 (Cal. 2005)).

¹⁶ *Id.* at 1618 (reasoning that nothing in the California Constitution prohibits contractual jury trial waivers and comparing jury trial waivers with arbitration clauses).

¹⁷ See *Grafton Partners*, 36 Cal. 4th at 951-970 (“The difficulty with the analysis in *Trizec* is that it is inconsistent with an established line of cases beginning with an early decision of this court.” *Id.* at 952.).

¹⁸ 5 Cal. 112 (Cal. 1855) (overruled in part by *People ex rel. Attorney Gen. v. Provines*, 34 Cal. 520, 526 (Cal. 1868)).

¹⁹ *Grafton Partners*, 36 Cal. 4th at 952 (citing *Exline*, 5 Cal. at 112-13). The Court further noted that, “[a]pplying [its] decisions and examining the history of the constitutional provision, the Court of Appeal in [*Grafton Partners*] similarly concluded that a waiver of the right to jury trial is permissible only to the extent expressly authorized by statute.” *Id.* (noting that, “the Court of Appeal rejected the reasoning of ... *Trizec* that, although section 631 does not authorize predispute waivers of jury trial, such waivers, like those in arbitration agreements, are permissible on nonstatutory grounds.”).

²⁰ *Id.* at 955.

²¹ *Id.* (citing Cal. Code Civ. Proc. § 1281).

Properties, Inc. . . . holds that the right to jury trial may be waived in a manner that is without statutory authorization, it is disapproved.”²³

The *Grafton Partners* Court also concluded that Code of Civil Procedure “section 631 applies only once there is a pending action – once the parties have ‘submitt[ed] their controversy to a court of law.’”²⁴ PriceWaterhouseCoopers argued that Code of Civil Procedure section 631(d)(2) permitted contractual jury trial waivers as long as the waiver was filed with the clerk or court.²⁵ Relying on *Madden v. Kaiser Foundation Hospitals*,²⁶ the Court did not find this argument compelling.²⁷ Rather, the Court noted that, “when the Legislature has authorized waiver of the right to trial in a court of law prior to the emergence of a dispute, it has done so explicitly.”²⁸ Inviting specific legislation on this issue, the Court “conclude[d] it is for the Legislature, not this [C]ourt, to determine whether, and under what circumstances, a predispute waiver of jury trial will be enforceable in this state.”²⁹ Significantly, rejecting the argument of PriceWaterhouseCoopers and several of the *amicus curiae* that commercial jury trial waivers are so prevalent that the Court’s decision should only apply prospectively, the Court ruled that its decision will apply retrospectively.³⁰

Although the Court unanimously affirmed the decision of the Court of Appeal in holding predispute jury trial waivers unenforceable, Justice Chin authored a concurring opinion “to urge the Legislature to enact legislation expressly authorizing predispute jury

²² *Id.* (citing *Madden v. Kaiser Foundation Hosps.*, 17 Cal. 3d 699, 713 (Cal. 1976)).

²³ *Id.* at 956.

²⁴ *Id.* at 957 (quoting *Madden*, 17 Cal. 3d at 713).

²⁵ *See id.* at 956-957.

²⁶ 17 Cal. 3d 699 (Cal. 1976).

²⁷ *See id.* at 957-958. Not persuaded by PriceWaterhouseCoopers’ attempt to direct the Court’s attention to the “plain language” of section 631(d)(2), the Court articulated that, “[b]ecause our state Constitution identifies the right to jury as ‘inviolable,’ any ambiguity or doubt concerning the waiver provisions of section 631 must be ‘resolved in favor of according to a litigant a jury trial.’” *Id.* at 958 (quoting *Loranger v. Nadeau*, 215 Cal. 362, 368 (Cal. 1932) (overruled on other grounds by *Reich v. Purcell*, 67 Cal. 2d 551, 555 (Cal. 1967))).

²⁸ *Id.* at 960.

²⁹ *Id.* 967.

³⁰ *Id.*

waivers.”³¹ According to Justice Chin, in light of the fact that “the Legislature has prescribed methods by which a party may impliedly waive, i.e., forfeit, the right to a jury trial by failing to undertake certain actions, . . . it makes little sense to authorize such forfeitures, and yet categorically prohibit knowing and voluntary jury trial waivers simply because they are made before any dispute arises.”³² In his concurring opinion, Justice Chin arguably analyzed the issue with more of an eye towards the practical implications³³ of the Court’s decision and its commercial impact.³⁴ In short, based on the clear invitation presented by Justice Chin’s concurring opinion, it is likely specific legislation will ultimately abrogate *Grafton Partners* and statutorily add an additional basis for waiver of the right to jury trial. For the time, however, *Grafton Partners* will have a significant impact on the litigation of many franchise disputes.

B. *Discover Bank v. Superior Court*: California Supreme Court Holds Consumer Class Arbitration Waiver Unenforceable

In *Discover Bank v. Superior Court*,³⁵ the California Supreme Court addressed “the validity of a provision in an arbitration agreement . . . forbidding classwide arbitration.”³⁶ Ultimately, the Court “conclude[d] that, at least under some circumstances, . . . class action waivers in consumer contracts of adhesion are unenforceable, whether the consumer is being asked to waive the right to class action litigation or the right to classwide arbitration.”³⁷

³¹ *Id.* at 968 (Chin, J., concurring).

³² *Id.*

³³ “As a practical matter, in a diversity action, a federal court will routinely enforce a knowing and voluntary predispute jury waiver as a matter of federal law.” *Id.* at 969 (noting that the Court’s holding “prohibit[s] the same knowing and voluntary waiver if parties filed their action in state court.”).

³⁴ Justice Chin supported “join[ing] other jurisdictions in recognizing that ‘there is no abstract public policy against contractual waivers of the right to a civil jury trial.’” *Id.* (citing *Okura & Co. v. Careau Group.*, 783 F. Supp. 482, 488 (C.D. Cal. 1991)). Moreover, Justice Chin appeared to empathize with the argument of the “numerous amici curiae [who] argue[d] that barring predispute jury waivers will have far-reaching negative consequences.” *Id.* Justice Chin noted, however, that if such concerns are valid, “the Legislature has yet more reason to adopt the majority rule that predispute jury waivers are enforceable.” *Id.*

³⁵ 36 Cal. 4th 148 (Cal. 2005) (on remand, writ granted by *Discover Bank v. Superior Court*, 2005 Cal. App. LEXIS 1875 (Cal. Ct. App. Dec. 7, 2005)).

³⁶ *Id.* at 152.

1. Factual Background

Discover Bank involved a California credit-cardholder who alleged that Discover Bank had a business practice of falsely representing to cardholders that certain late payment fees would not be charged if payment was received by a certain date and time which resulted in small damages to individual cardholders, but substantial sums in the aggregate.³⁸ The plaintiff filed a complaint for damages based on this allegedly deceptive and unfair business practice in Los Angeles County Superior Court.³⁹ Defendant Discover Bank later successfully moved to compel arbitration under an arbitration agreement that the plaintiff signed.⁴⁰

Thereafter, the plaintiff sought to “pursue a classwide arbitration, which is well accepted under California law.”⁴¹ Common to many consumer contracts, however, the “plaintiff’s arbitration agreement with Discover Bank ha[d] a clause forbidding classwide arbitration.”⁴² “The trial court ruled that the class arbitration waiver was unconscionable and enforced the arbitration agreement with the proviso that [the] plaintiff could seek classwide arbitration.”⁴³ However, “[t]he Court of Appeal, without disputing that such class arbitration waivers may be unconscionable under California law . . . , held that the

³⁷ *Id.* at 153 (noting further that the Court of Appeal was incorrect in holding that the Federal Arbitration Act (FAA) “preempts California law in this respect.”) (remanding to the Court of Appeal to decide a choice-of-law issue).

³⁸ *Id.* at 152.

³⁹ *See id.* The plaintiff’s putative class action complaint alleged two causes of action for breach of contract and violation of the Delaware Consumer Fraud Act (Del. Code Ann., Title 6, Sections 2511-2527). *Id.* at 154.

⁴⁰ *Id.* at 152. In opposing the motion, the plaintiff contended “that the class action waiver was unconscionable and unenforceable under California law.” *Id.* at 154. Conversely, Discover Bank “argued that the FAA require[d] the enforcement of the express provisions of [the] arbitration clause, including class action waivers.” *Id.* at 155. Initially, the trial court “granted Discover Bank’s motion in its entirety under Delaware law.” *Id.*

⁴¹ *Id.* at 152 (quoting *Keating v. Superior Court*, 31 Cal. 3d 584, 613-14 (Cal. 1982), overruled on other grounds in *Southland Corp. v. Keating*, 465 U.S. 1 (1984)).

⁴² *Id.* (noting that “the agreement [also] ha[d] a Delaware choice-of-law provision.”). Discover Bank contended that “Delaware law allows contracting parties to waive class action remedies.” *Id.*

⁴³ *Id.* at 153. Following the lower court’s ruling on a motion for reconsideration, Discover Bank filed a writ petition seeking reinstatement of the trial court’s original ruling that prohibited class arbitration. *Id.* at 155.

Federal Arbitration Act (FAA) (9 U.S.C. § 1 et seq.) preempts the state law rule that class arbitration waivers are unconscionable.”⁴⁴

2. Analysis

Referring to its prior decisions in *Vasquez v. Superior Court*,⁴⁵ *Linder v. Thrifty Oil Co.*,⁴⁶ *Blue Chip Stamps v. Superior Court*,⁴⁷ and the United States Supreme Court’s decision in *Amchem Products, Inc. v. Windsor*,⁴⁸ the Discover Bank Court began its analysis with a recitation of the practical benefits and public policy justification of class action litigation⁴⁹ and classwide arbitration.⁵⁰ Most notably, however, the Court relied on *Keating v. Southland Corporation*.⁵¹ In *Keating*, the California Supreme Court, while

⁴⁴ *Id.* at 153. After the motion to compel arbitration was granted, “the Fourth District Court of Appeal decided *Szetela v. Discover Bank*, 97 Cal. App. 4th 1094 (Cal. Ct. App. 2002), which held . . . that a virtually identical class action waiver was unconscionable.” *Id.* at 155. As the Supreme Court noted, the Court of Appeal “did not take issue with the premise that class action waivers are unenforceable. . . .” *Id.* at 155. Rather, the Court of Appeal upheld the class action waiver in reliance on FAA preemption. *See id.*

⁴⁵ 4 Cal. 3d 800 (Cal. 1971).

⁴⁶ 23 Cal. 4th 429 (Cal. 2000).

⁴⁷ 18 Cal. 3d 381 (Cal. 1976) (Tobriner, J., concurring).

⁴⁸ 521 U.S. 591 (1997).

⁴⁹ “[T]he class suit ‘both eliminates the possibility of repetitious litigation and provides small claimants with a method of obtaining redress for claims which would otherwise be too small to warrant individual litigation.’” *Discover Bank*, 36 Cal. 4th at 157 (quotations omitted).

⁵⁰ *Discover Bank*, 36 Cal. 4th at 156-58.

⁵¹ *See id.* at 157 (citing *Keating v. Southland Corporation*, 31 Cal. 3d 584 (Cal. 1982) (Appeal dismissed in party, Reversed in party by *Southland Corp. et al. v. Keating et al.*, 465 U.S. 1, 104 St. Ct. 852 (1984). On appeal, the United States Supreme Court, dismissed the part of the appeal relating to the propriety of superimposing class action procedures on arbitration agreements covered by the Federal Arbitration Act; and reversed the judgment of the California Supreme Court denying enforcement of the arbitration agreements.). In *Keating*, the plaintiffs, numerous 7-Eleven franchisees sought to invalidate an arbitration agreement and proceed with a class action to enforce their rights. Although the *Keating* Court largely upheld the arbitration agreement, it

acknowledging the additional need for judicial oversight by comparison to traditional arbitration, widely endorsed the concept of the classwide arbitration procedure.⁵² The *Discover Bank* Court recognized that “*Keating’s* endorsement of classwide arbitration has been echoed by subsequent Court of Appeal decisions.”⁵³

Prior to *Discover Bank*, two recent cases addressed the issue of whether class action waivers may be enforceable. In *America Online, Inc. v. Superior Court*,⁵⁴ the Court of Appeal analyzed the validity of a class action waiver outside the arbitration context.⁵⁵ Additionally, in *Szetela v. Discover Bank*,⁵⁶ the Court of Appeal refused to enforce a class arbitration waiver.⁵⁷

After thoroughly analogizing and distinguishing *AOL* and *Szetela*, the *Discover Bank* Court noted that, “at least some class action waivers in consumer contracts are unconscionable under California law.”⁵⁸ “[A]lthough adhesive contracts are generally enforced . . . , class action waivers found in such contracts may also be substantively unconscionable inasmuch as they may operate effectively as exculpatory contract clauses

simultaneously emphasized the benefits of the class procedure. *Keating*, 31 Cal. 3d at 609.

⁵² *Id.* at 613. Although it “judicially authorized classwide arbitration,” *Keating* did not directly answer “the question whether a class action waiver may be unenforceable as contrary to public policy or unconscionable.” *Discover Bank*, 36 Cal. 4th at 158.

⁵³ 36 Cal. 4th at 157-58 (citing *Sanders v. Kinko’s, Inc.*, 99 Cal. App. 4th 1106 (Cal. Ct. App. 2002); and *Blue Cross of Calif. v. Superior Court*, 67 Cal. 4th 42 (Cal. 1998)).

⁵⁴ 90 Cal. App. 4th 1 (Cal. Ct. App. 2001).

⁵⁵ In *America Online, Inc.*, multiple former AOL subscribers alleged that AOL continued to charge monthly services charges to their credit card accounts after their subscriptions were cancelled. *Id.* at 5. The plaintiffs filed a class action for violations of the Consumer Legal Remedies Act (Cal. Civ. Code § 1750) and Unfair Business Practices Act (Cal. Bus. & Prof. Code § 17200 *et seq.*). America Online was ultimately decided based on choice-of-law and forum selection issues because the AOL subscription contracts contained Virginia forum selection and choice of law. *See Discover Bank*, 36 Cal. 4th at 158-59.

⁵⁶ *Szetela v. Discover Bank, Szatela*, 97 Cal. App. 4th 1094, 1097 (Cal. Ct. App. 2002).

⁵⁷ *Id.* at 1100 (finding procedural unconscionability in the adhesive nature of the consumer contract).

⁵⁸ *Discover Bank*, 36 Cal. 4th at 160.

that are contrary to public policy.”⁵⁹ Importantly, however, the Court was careful to explain that “[c]lass action and arbitration waivers are not, in the abstract, exculpatory clauses.”⁶⁰

Distinguishable from most franchisee/franchisor litigation but analogous to claims brought by consumers against franchisees and franchisors, the Court noted that, “damages in consumer cases are often small because ‘[a] company which wrongfully exacts a dollar from each of millions of customers will reap a handsome profit.’”⁶¹ Thus, “the class action is often the only effective way to halt and redress such exploitation.”⁶² Furthermore, in view of the one-sided nature of class arbitration waivers, the Court observed that such “one-sided, exculpatory contracts in a contract of adhesion, at least to the extent they operate to insulate a party from liability that otherwise would be imposed under California law, are generally unconscionable.”⁶³

The *Discover Bank* Court “acknowledge[d] that many other courts disagree” with its holding and rationale.⁶⁴ Furthermore, the Court rejected Discover Bank’s argument that *Washington Mutual Bank v. Superior Court*⁶⁵ supported the conclusion that class

⁵⁹ *Id.* at 160-161 (citing *Graham v. Scissor-Tail, Inc.*, 28 Cal. 3d 807, 817-18 (Cal. 1981)). *See also* Cal. Civ. Code § 1668 (“All contracts which have for their object, directly or indirectly, to exempt anyone from responsibility for his own fraud, or willful injury to the person or property of another, or violation of law, whether willful or negligent, are against the policy of the law.”).

⁶⁰ *Discover Bank*, 26 Cal. 4th at 161.

⁶¹ *Id.* (quoting *Linder v. Thrifty Oil Co.*, 23 Cal. 4th 429, 446 (Cal. 2000)).

⁶² *Id.*

⁶³ *Discover Bank*, 36 Cal. 4th at 161.

⁶⁴ *Id.* *See, e.g., Strand v. U.S. Bank Nat’l Assoc. ND*, 2005 ND 68, 693 N.W. 2d 918, 926 (N.D. 2005) (This opinion is subject to petition for rehearing and cannot be considered final until disposition of such petition for rehearing by the Court or expiration of 14 days from the filing date.); *Blaz v. Belfer*, 368 F.3d 501, 504-05 (5th Cir. 2004); *Johnson v. West Suburban Bank*, 225 F.3d 366, 369 (3rd Cir. 2000); *Champ v. Siegel Trading Co., Inc.*, 55 F.3d 269, 277 (7th Cir. 1995). *But see Leonard v. Terminex Int’l Co. L.P.*, 854 So. 2d 529, 538 (Ala. 2002) (holding class action waiver and damages limitation unconscionable); *State ex rel. Dunlap v. Berger*, 211 W. Va. 549, 567 S.E.2d 265, 278 (W. Va. 2002) (holding limitation on class action rights unconscionable) (*remanded by, sub nomine at Dunlap v. Friedman’s, Inc.*, 2003 W. Va. LEXIS 45 (W. Va. May 6, 2003)); *Powertel, Inc. v. Bexley*, 743 So.2d 570, 576 (Fla. Ct. App. 1999).

⁶⁵ 24 Cal. 4th 906 (Cal. 2001).

arbitration waivers are not unconscionable.⁶⁶ Moreover, the Court was not “persuaded by the rationale . . . that the potential availability of attorney fees to the prevailing party in arbitration or litigation ameliorates the problem posed by . . . class action waivers.”⁶⁷ Significantly, under *Discover Bank*, “not . . . all class action waivers are necessarily unconscionable.”⁶⁸ To the contrary, the Court reasoned:

[W]hen the waiver is found in a consumer contract of adhesion in a setting in which disputes between the contracting parties predictably involve small amounts of damages, and when it is alleged that the party with the superior bargaining power has carried out a scheme to deliberately cheat large numbers of consumers out of individually small sums of money, then, at least to the extent the obligation at issue is governed by California law, the waiver becomes in practice the exemption of the party ‘from responsibility for [[its] own fraud, or willful injury to the person or property of another.’⁶⁹

Thus, based on its narrowly tailored holding, it is likely that *Discover Bank* will be significant not for its impact on franchise litigation – but lack thereof. In other words, a fundamental understanding of the *Discover Bank* limitations will be critical to survive the argument of consumer or franchisee plaintiffs that all classwide arbitration waivers contained in the contracts of franchisees or franchisors are invalid. Such an argument would be flawed and misinterpret *Discover Bank*.

On the issue of FAA preemption, distinguishing the rationale of the Court of Appeal and *Discover Bank*’s reliance on *Gilmer v. Interstate/Johnson Lane Corp.*,⁷⁰ and *Green Tree Financial Corp. v. Bazzle*,⁷¹ the Court, relying largely on *Perry v. Thomas*,⁷² the *Discover Bank* Court concluded that a state law rule against class arbitration is not

⁶⁶ *Discover Bank*, 36 Cal. 4th at 161 (“No class action waiver was at issue in *Washington Mutual Bank*.”).

⁶⁷ *Id.* at 162 (citing *Snowden v. Checkpoint Check Cashing*, 290 F. 3d 631, 638 (4th Cir. 2002)).

⁶⁸ *Id.*

⁶⁹ *Id.* at 162-63 (quoting Cal. Civ. Code § 1668).

⁷⁰ 500 U.S. 20 (1991).

⁷¹ 539 U.S. 444 (2003).

⁷² 482 U.S. 483 (1987).

preempted by the FAA.⁷³ Thus, the Court held that “the FAA does not prohibit a California court from refusing to enforce a class action waiver that is unconscionable.”⁷⁴

C. *Nagrampa v. Mailcoups, Inc.*: Ninth Circuit Reasons that Arbitrators Rather than Courts Are to Rule on Claims of *Substantive Unconscionability of Arbitration Clauses*

In *Nagrampa v. Mailcoups, Inc., et al.*,⁷⁵ the United States Court of Appeals for the Ninth Circuit addressed the question of “who determines whether an agreement containing an arbitration clause is unconscionable: the arbitrator or the court.”⁷⁶

1. Factual Background

Having worked for a substantial period of time in the marketing field, the plaintiff entered into a franchise agreement with the defendant to operate one of Mailcoups, Inc.’s company mail-advertising franchises.⁷⁷ The franchise agreement signed by the parties “include[d] a clause requiring the arbitration of any dispute ‘arising out of or relating to’ the franchise agreement.”⁷⁸ The plaintiff claimed that the franchise agreement was “non-

⁷³ See generally *Discover Bank*, 36 Cal. 4th at 163-68.

⁷⁴ *Id.* at 173. In a lengthy dissent, Justice Baxter stressed that the majority’s position was “at odds with the vast weight of authority elsewhere,” and the decision was “simply moot under the particular circumstances.” *Id.* at 175 (Baxter, J., dissenting). Justice Baxter emphasized in his dissent that, “Delaware permits arbitration agreements that preclude class treatment, even if such provisions are contained in standard-form consumer contracts.” *Id.* at 176. (Baxter, J., dissenting) (citations omitted). Moreover, Justice Baxter urged that “Delaware’s position is in accord with the vast majority of decisions, applying federal law or the law of other states, which hold that arbitration clauses are not invalid either because they exclude class treatment or because they preclude such treatment by failing to expressly provide for it.” *Id.* (Baxter, J., dissenting) (citations omitted). In short, Justice Baxter would have “h[e]ld the parties to their agreement, expressly governed by Delaware law, which call[ed] for individual arbitration of disputes. . . . [and] would [have] affirm[ed] the judgment of the Court of Appeal. . . .” *Id.* at 184-85 (Baxter, J., dissenting).

⁷⁵ 401 F. 3d 1024 (9th Cir. 2005) (Vacated by, Rehearing, en banc, granted by *Nagrampa v. Mailcoups Inc.*, 413 F.3d 1024 (9th Cir. June 28, 2005) (“The three-judge panel opinion shall not be cited as precedent by or to this court or any district court of the Ninth Circuit, except to the extent adopted by the en banc court.”).)

⁷⁶ *Nagrampa*, 401 F. 3d at 1026.

⁷⁷ See *id.*

negotiable” and that the defendant failed to “inform her about the arbitration clause or the costs associated with arbitration.”⁷⁹

After operating the mail-advertising franchise for two years, the franchise failed and the franchisee plaintiff terminated the franchise agreement in the fall of 2000.⁸⁰ In response to Nagrampa’s termination of the franchise agreement, Mailcoups initiated arbitration proceedings with the American Arbitration Association against Nagrampa.⁸¹ Thereafter, Nagrampa filed a complaint against Mailcoups and the AAA in state court in California, seeking to enjoin enforcement of the arbitration clause and alleging causes of action for: (1) fraud and misrepresentation; (2) violation of the Consumer Legal Remedies Act; (3) California’s franchise laws; and (4) unfair competition.⁸²

The defendant moved to compel arbitration and also moved to dismiss the court proceedings.⁸³ In opposition to the motion to compel arbitration, the plaintiff “argued that the arbitration clause was unenforceable on grounds of unconscionability.”⁸⁴ Reasoning that the arbitration clause was valid, the district court granted the defendant’s motion to dismiss, but denied the motion to compel arbitration.⁸⁵

2. Analysis of the Unconscionability Argument

The Ninth Circuit began its analysis by recognizing that, “[u]nder California law, the party challenging the validity of an arbitration clause has the burden of proving

⁷⁸ *Id.*

⁷⁹ *Id.*

⁸⁰ *See id.* at 1026.

⁸¹ *See id.* (noting that “Nagrampa initially participated with the prehearing procedures,” but thereafter discontinued doing so).

⁸² *See id.* at 1026-27. The case was later removed to federal court based on diversity jurisdiction. *See id.* at 1027.

⁸³ *Id.*

⁸⁴ *Id.*

⁸⁵ *See Nagrampa*, 401 F. 3d at 1027. “The district court denied the motion to compel arbitration because [Section] 4 of the Federal Arbitration Act (“FAA”) requires that an arbitration hearing take place in the district in which the motion to compel was filed.” *Id.* at n. 2 (citing 9 U.S.C. § 4). The arbitration agreement provided that the arbitration was to occur in Boston, not California. *See id.* Thus, the District of Massachusetts, rather than the Central District of California, was the proper venue for the defendant’s motion to compel arbitration. *Id.*

unconscionability.”⁸⁶ The *Nagrampa* court further observed that “[u]nconscionability has both a procedural and substantive element, the former focusing on oppression or surprise due to unequal bargaining power, the latter on overly harsh or one-sided results.”⁸⁷ Finally, the Ninth Circuit observed:

Although both elements must be present for a court to exercise its discretion to invalidate an agreement as unconscionable, they need not be present in the same degree. Because procedural and substantive unconscionability exist on a sliding scale, ‘the more substantively oppressive the contract term, the less evidence of procedural unconscionability is required to come to the conclusion that the term is unenforceable, and vice versa.’⁸⁸

On appeal, the plaintiff contended that the arbitration clause was “procedurally unconscionable because the franchise agreement . . . constitute[d] a contract of adhesion.”⁸⁹ Relying on the United States Supreme Court’s decision in *Prima Paint Corp. v. Flood & Conklin Mfg. Co.*,⁹⁰ which “defines the respective roles of courts and arbitrators in deciding matters of contractual validity[,]”⁹¹ the Ninth Circuit Court of Appeals concluded that “[a]ny issues that relate to the making of the franchise agreement as a whole must be referred to an arbitrator.”⁹²

Prior to *Nagrampa*, the Ninth Circuit had “refrained from expressly addressing *Prima Paint*’s implications for contract of adhesion arguments.”⁹³ Applying the

⁸⁶ *Id.* at 1027 (citing *Szetela v. Discover Bank*, 97 Cal. App. 4th 1094 (2002)).

⁸⁷ *Id.* (quoting *Armendariz v. Found. Health Psychcare Servs., Inc.*, 24 Cal. 4th 83 (2000).)

⁸⁸ *Id.* (quotations omitted).

⁸⁹ *Id.* at 1027.

⁹⁰ 388 U.S. 395 (1967).

⁹¹ *See Nagrampa* 401 F. 3d at 1027.

⁹² *Id.* at 1028.

⁹³ *Id.* Previously, in *Ticknor v. Choice Hotels International, Inc.*, 265 F. 3d 931 (9th Cir. 2001), the Ninth Circuit held that an arbitration clause of a franchise agreement was unconscionable because the entire agreement constituted a contract of adhesion. *Id.* at 941. *Nagrampa*, however, expressly distinguished *Ticknor* on the grounds that *Ticknor* “provides no analysis of whether a court or an arbitrator should properly decide the contract of adhesion question.” *Nagrampa*, 401 F. 3d at 1028. Additionally, in arriving

principles of *Prima Paint* and “[i]n accordance with the convincing analysis of . . . sister circuits, [the Ninth Circuit] h[e]ld that [an] arbitrator must decide whether an agreement that contains an arbitration clause is a contract of adhesion because th[e] issue pertains to the making of the agreement as a whole and not to the arbitration clause specifically.”⁹⁴ Thus, as applied to the facts of the case, the Ninth Circuit held that “[i]t accordingly rests within the province of the arbitrator – and not within the judicial purview – to resolve Nagrampa’s claim that the franchise agreement [wa]s a contract of adhesion.”⁹⁵

Importantly, however, *Nagrampa* does not preclude courts from addressing the alleged procedural unconscionability of an arbitration clause’s validity.⁹⁶ Rather, *Nagrampa* only applies to claims of substantive unconscionability.⁹⁷ In conclusion, “[b]ecause [the plaintiff’s] contract of adhesion argument [wa]s a matter for the arbitrator to decide – and because . . . she ha[d] not met her burden of proving that the arbitration agreement [wa]s procedurally unconscionable[, the Ninth Circuit did] not reach the question of whether the agreement [wa]s substantively unconscionable.”⁹⁸ In the wake of *Nagrampa*, in opposing a petition or motion to compel arbitration, plaintiffs will

at its ultimate conclusion that whether an arbitration clause is unconscionable should be decided by an arbitrator, the Ninth Circuit took great pains to distinguish a series of other cases. For example, the Ninth Circuit articulated that “those decisions in which we have held that an arbitration agreement itself constituted a contract of adhesion have all concerned stand-alone arbitration agreements, rather than arbitration clauses that were embedded in larger contracts.” *See id.* at 1029 (comparing *Ferguson v. Countrywide Credit Indus., Inc.*, 298 F. 3d 778, 784 (9th Cir. 2002) and *Circuit City Stores, Inc. v. Adams*, 279 F. 3d 889, 893 (9th Cir. 2002)).

⁹⁴ *Id.* at 1028. “This conclusion not only comports with the holding of *Prima Paint* but also gives effect to ‘Congress’s intent to move the parties to an arbitrable dispute out of court and into arbitration as quickly and easily as possible.’” *Id.* (quoting *Bushley v. Credit Suisse First Boston*, 360 F. 3d 1149, 1153 (9th Cir. 2004)).

⁹⁵ *Id.* at 1029. The plaintiff also argued that the arbitration clause was procedurally unconscionable because the provision was on the twenty-fifth page of the thirty-page contract. *See id.* (citing *Brookwood v. Bank of America*, 45 Cal. App. 4th 1667, the Ninth Circuit quickly discounted this argument. *See Nagrampa*, 401 F. 3d at 1029-30.).

⁹⁶ “*Prima Paint* does not preclude us from considering these additional procedural unconscionability arguments because they pertain specifically to the arbitration clause’s validity.” *Nagrampa*, 401 F. 3d at 1029 (citing *Prima Paint*, 388 U.S. at 404).

⁹⁷ *See id.*

⁹⁸ *Id.* at 1030.

emphasize that the particular arbitration clause is procedurally unconscionable and try to avoid substantive unconscionability arguments.⁹⁹

D. *Snowney v. Harrah's Entertainment: California Supreme Court Upholds Exercise of Personal Jurisdiction Over Nonresident Hotel Chain Based on Its Website and Other Online Contacts With California Residents*

In June of 2005, in *Snowney v. Harrah's Entertainment*,¹⁰⁰ the California Supreme Court held that a popular Nevada hotel chain with just limited direct business ties to California was subject to personal jurisdiction in California courts based on the fact that the hotel targeted California residents through its website and obtains a significant portion of its business from the state.

Snowney involved a California resident who filed a class action lawsuit for deceptive trade practices and false advertising in California against a group of Nevada hotels for failing to provide notice of an energy charge billed to hotel guests. The nonresident defendants asserted that they were not subject to the personal jurisdiction of California courts because they lacked the requisite minimum contacts with the forum state.

The *Snowney* Court, however, concluded that, in light of the defendants' substantial advertising and commercial interaction with California residents, the defendants were subject to the exercise of personal jurisdiction by California courts. The Court emphasized that the defendants: (1) advertised extensively to California residents through billboards, newspapers, and radio and television in California; (2) maintained a website regularly used by California residents; (3) accepted reservations from California residents through their website and via a toll-free number listed on the website and in their Internet advertisements; (4) obtained a substantial percentage of their guests from California; and (5) routinely sent promotional mailings to California residents. Based on the totality of the nonresident defendant's business activities, the California Supreme Court held that the out-of-state hotels' solicitation of California guests through advertising and the website was sufficient to support the exercise of personal jurisdiction.

Snowney reflects an increasing attention to a nonresident defendant's online contacts with a particular forum and its residents when deciding whether to exercise personal jurisdiction. Ultimately, under *Snowney*, the operation of an interactive website which allows online reservations or other commercial activity, i.e., anything ranging from providing driving directions to selling products, may subject nonresident franchisees or

⁹⁹ In *Vlahos v. International Baking Co., Inc.*, a recent unpublished and non-citable franchise case from the First Appellate District, the Court of Appeal refused to apply *Nagrampa* or acknowledge its value as precedent in California state courts. See www.courtinfo.ca.gov/opinions/nonpub/A102335.DOC (noting that *Vlahos* is unpublished and non-citable pursuant to Rule 977 of the California Rules of Court).

¹⁰⁰ 35 Cal. 4th 1054, 112 P.3d 28 (Cal. 2005).

franchisors to the jurisdiction of California courts. Pursuant to *Snowney* and a recent line of other internet jurisdiction cases, whether a franchisee or franchisor's online presence will be sufficient under a traditional *International Shoe Co. v. Washington* minimum contacts analysis requires a case-by-case analysis. Thus, in the wake of *Snowney*, franchisees and franchisors should thoughtfully design their website with an eye towards maximizing their marketing objectives and advertising goals while concurrently minimizing the risk of being hauled into court in some foreign forum.

III. Conclusion

As practitioners in the area of franchise law, these cases will not only impact the way we practice law, but, even more importantly, will effect the business of our clients. Accordingly, it will be interesting to follow and gauge the extent to which these decisions change our practice and the policies of our clients in the near future.