

# **An Overview of New Franchise Legislation and Pre-Dispute Arbitration Provisions: Issues of Unconscionability and Enforceability under California Law**

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## **I. INTRODUCTION**

In Richard Byerrum and Clinton, Inc. v. Re/Max of California and Hawaii, Inc.,<sup>1</sup> the court held an arbitration provision unenforceable both on procedural and substantive unconscionability grounds. The court found the procedural prong was “unconscionable based on the evidence presented that it’s a take-it-or-leave-it forum [*sic*] contract with respect to the arbitration clause.” The substantive prong was unconscionable because of the lack of mutuality – specifically, because Byerrum could only arbitrate his claims, whereas Re/Max was free to choose to use the courts or arbitration to present its claims. *Id.*

Byerrum follows other California state court decisions which have sought to limit the broad federal policy of favoring and enforcing arbitration clauses. In the wake of the Byerrum decision, franchisors should take a closer look at their arbitration provisions because traditional “franchisor friendly” provisions increasingly are subject to growing scrutiny by California state courts.

## **II. UNCONSCIONABILITY**

In California, in order to invalidate a contract or contractual provision as unconscionable, the contract or provision must be both (1) procedurally unconscionable, and (2) substantively unconscionable.<sup>2</sup> However, the procedural and substantive elements of unconscionability need not be present in the same degree.<sup>3</sup>

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<sup>1</sup> CCH Business Franchise Guide ¶ 12,743 (Cal. Sup. Ct. 2003).

<sup>2</sup> See A&M Produce Co. v. FMC Corp., 135 Cal.App.3d 473, 486 (1982); Armendariz v. Foundation Health Psychcare Services, Inc., 24 Cal.4th 83, 114 (2000); Little v. Auto Stiegler, Inc., 29 Cal.4th 1064, 1071 (2003).

<sup>3</sup> See Armendariz (applying a sliding scale so that “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).

## A. Procedural Unconscionability

“Procedural unconscionability concerns the manner in which the contract was negotiated and the circumstances of the parties at that time.”<sup>4</sup> An analysis of procedural unconscionability focuses on whether the process of entering into the contract involved the factors of “oppression” and “surprise.”<sup>5</sup>

### 1. Oppression

“The oppression component arises from an inequality of bargaining power of the parties to the contract and an absence of real negotiation or a meaningful choice on the part of the weaker party.”<sup>6</sup>

Because the above language parallels the definition of an adhesion contract,<sup>7</sup> many courts begin the unconscionability analysis by first determining whether a contract is one of adhesion.<sup>8</sup> There are even some decisions in which courts have ruled that an adhesion contract alone was sufficient to support a finding of procedural unconscionability.<sup>9</sup>

However, the more prevalent view is that finding an agreement to be an adhesion contract is only “the beginning and not the end of the analysis insofar as enforceability of its terms is concerned.”<sup>10</sup> “A contract of adhesion is fully enforceable according to its terms ... unless certain other factors are present which, under established legal rules – legislative or judicial – operate to render it otherwise.”<sup>11</sup>

Not all adhesion contracts are procedurally unconscionable.<sup>12</sup> A contract of adhesion is oppressive only if the weaker party “lacks not only the opportunity to bargain but also any realistic opportunity to look elsewhere for a more favorable contract.”<sup>13</sup> The arbitration clause in

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<sup>4</sup> Kinney v. United HealthCare Services, Inc., Cal.App.4th 1322, 1329 (1999).

<sup>5</sup> See Armendariz at 114 (citing A&M Produce at 487).

<sup>6</sup> See Kinney at 1329.

<sup>7</sup> A contract of adhesion is defined as “a standardized contract, which, imposed and drafted by the party of superior bargaining strength, relegates the subscribing party only the opportunity to adhere to the contract or reject it.” See Graham v. Scissor-Tail, Inc., 28 Cal.3d 807, 817 (1981) (quoting Neal v. State Farm Ins. Cos., 188 Cal.App.2d 690, 694 (1961)).

<sup>8</sup> “Unconscionability analysis begins with an inquiry into whether the contract is one of adhesion.” Armendariz at 113 (citing Graham at 817-819).

<sup>9</sup> See e.g. Flores v. Transamerica HomeFirst, Inc., 93 Cal.App.4th 846, 853 (2001) (holding that “a finding of a contract of adhesion is essentially a finding of procedural unconscionability”).

<sup>10</sup> See Graham at 819 (citing Wheeler v. St. Joseph Hospital, 63 Cal.App.3d 345, 357 (1976)).

<sup>11</sup> See Graham at 819-20.

<sup>12</sup> See California Grocers Association, Inc. v. Bank of America, 22 Cal.App.4th 205, 214 (1994) (recognizing that adhesiveness is not *per se* oppressive). See also Morris v. Redwood Empire Bancorp, 128 Cal.App.4th 1305, 1318 (2005) (criticizing the “reflexive” conclusion by some courts in finding that an adhesion contract alone satisfies the procedural element of unconscionability and ignoring other procedural factors such as surprise).

<sup>13</sup> See Morris at 1320 (citing Madden v. Kaiser Foundation Hospitals, 17 Cal.3d 699, 711 (1975)).

an adhesion contract was enforced on the plaintiff in Madden v. Kaiser Foundation Hospital as she had the opportunity to select other medical plans, some of which did not contain an arbitration clause.<sup>14</sup>

## 2. Surprise

The component of surprise arises when the challenged terms are hidden in standard form contracts provided by the party who seeks to enforce them.<sup>15</sup> A challenged term is hidden if it is written in small print, buried in a long standard form, or otherwise beyond the reasonable expectations of the weaker party.<sup>16</sup>

If a party had the opportunity to read a contract but failed to do so before signing, it cannot later claim surprise at the inclusion of a clause, *e.g.*, an arbitration provision.<sup>17</sup> The courts have also recognized that a clear heading may refute a claim of surprise.<sup>18</sup>

### B. Substantive Unconscionability

The substantive element of unconscionability focuses on the contractual terms, inquiring whether they are so unjustifiably one-sided that they “shock the conscience” or impose a harsh or oppressive result.<sup>19</sup> “As has been recognized, unconscionability turns not only on a one-sided result, but also on an absence of justification for it.”<sup>20</sup> Business realities may justify a party with superior bargaining strength in providing itself with an advantage in its arbitration agreement.<sup>21</sup>

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<sup>14</sup> See Madden at 711. *But cf.* Tunkl v. Regents of the University of California, 60 Cal.2d 92 (1963) (adhesive waiver of liability not enforced on patient when executed upon admission of patient to hospital); Little at 1071 (refusing to enforce an arbitration clause as “few employees are in a position to refuse a job because of an arbitration requirement”)

<sup>15</sup> Kinney at 1329.

<sup>16</sup> See Higgins v. The Superior Court of Los Angeles County, 140 Cal.App.4th 1238, 1252 (2006). Under Graham, an adhesion contract was to be enforced unless the contract or provision at issue did not fall within the reasonable expectations of the weaker party, or was unconscionable. See Graham at 820. In deference to Graham, recent cases address “reasonable expectations” when discussing the factor of “surprise” under the “procedural” element of the unconscionability inquiry. See also Harper v. Ultimo, 113 Cal.App.4th 1402, 1406 (2003).

<sup>17</sup> See West v. Henderson, 227 Cal.App.3d 1578, 1587 (1991) (holding that “parties to commercial contracts fail to read at their own peril” when the unsophisticated plaintiff “apparently saw no reason to protect her own interests at the outset,” and that “the only oppression on [the plaintiff] we perceive ... was self-imposed”).

<sup>18</sup> See Woodside Homes, Inc. v. The Superior Court of Riverside County, 107 Cal.App.4th 723, 729 (2003); *but cf.* Higgins at 1243 (finding that there is “surprise” where the arbitration clause is one paragraph among the twelve in the Miscellaneous section, none of which has a heading or title).

<sup>19</sup> See Armendariz at 117-18; 24 Hour Fitness, Inc. v. The Superior Court of Sonoma County, 66 Cal.App.4th 1199, 1213 (1998).

<sup>20</sup> See Armendariz at 117-18 (quoting A&M Produce at 487).

<sup>21</sup> Fitz v. NCR Corp., 118 Cal.App.4th 702, 723 (2004) (holding that “a contracting party with superior bargaining strength may provide extra protection for itself within the terms of the arbitration agreement if business realities create a special need for the advantage”).

A contract or a contractual term is not substantively unconscionable merely because it is unreasonable.<sup>22</sup> Unconscionability requires a “strong and manifest” inequality.<sup>23</sup>

A common element in all substantively unconscionable arbitration provisions is the lack of mutuality. All arbitration agreements must have at least “a modicum of bilaterality.”<sup>24</sup>

California state courts have identified the following arbitration provisions that may result in substantive unconscionability: (i) only the employee is required to arbitrate his/her claims;<sup>25</sup> (ii) an employer may appeal an arbitration award of over \$50,000;<sup>26</sup> (iii) only one party may seek appellate review of the arbitration decision;<sup>27</sup> (iv) unreasonable arbitration costs imposed on the employee;<sup>28</sup> (v) a shortening of the statute of limitations;<sup>29</sup> (vi) restrictions on discovery;<sup>30</sup> (vii) limitation on employee’s damage recovery;<sup>31</sup> (viii) unreasonable arbitration forum.<sup>32</sup>

### III. DISPUTE RESOLUTION PROVISIONS

#### 1. The Issues

Franchise agreements commonly require alternative dispute resolution (“ADR”). ADR provisions create a number of legal issues. First it is crucial that the franchise agreement make clear which ADR procedures are to be followed. Once that hurdle is cleared, the parties may be expected have conflicts over such items as the precise manner of ADR (*e.g.*, arbitrator selection), the venue of the ADR proceeding (*i.e.*, can a franchisor require a franchisee to travel to another jurisdiction for the proceeding?), the choice of law to govern the ADR proceeding, evidence which can and cannot be considered in the ADR proceeding, the effect of integration clauses, and the reviewability of any award rendered in an ADR proceeding. Other issues involve the measurement of damages, the availability of classwide relief, the effectiveness of waivers (*e.g.*, of jury trials, types of relief, and punitive damages), and provisions respecting limitations periods for claims.

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<sup>22</sup> See California Grocers at 214 (expressly rejecting “reasonableness” as “an amorphous standard [which] is far too subjective to provide adequate guidance”). See also Morris at 1322-23 (citing American Software, Inc. v. Ali, 46 Cal.App.4th1386, 1391 (1996) (admonishing against courts being “thrust in the paternalistic role of intervening to change contractual terms that the parties have agreed to merely because the court believes that the terms are unreasonable”).

<sup>23</sup> See California Grocers at 214 (citing Osgood v. Franklin, I Johns. Ch. 1, 21 (1816 N.Y.Ch.)).

<sup>24</sup> See Armendariz at 117 (citing Stirlen v. Supercuts, Inc., 51 Cal.App.4th 1519, 1541 (1997)).

<sup>25</sup> See Martinez v. Master Protection Corp., 2004 Cal. App. LEXIS 638.

<sup>26</sup> See Little (holding that the \$50,000 limit “inordinately benefits defendants”).

<sup>27</sup> See Higgins at 1254.

<sup>28</sup> Martinez; McManus v. CIBC World Markets Corp., 109 Cal. App. 4th 76 (2003).

<sup>29</sup> Martinez.

<sup>30</sup> *Id.*

<sup>31</sup> Pinedo v. Premium Tobacco Stores, Inc., 85 Cal. App. 4th 774 (2000).

<sup>32</sup> *Id.*

## 2. Case Law on Dispute Resolution Issues

### a. Availability of Arbitration

Section 2 of the Federal Arbitration Act ("FAA") provides that both pre-dispute and post-dispute arbitration agreements within its broad scope "shall be valid, irrevocable, and enforceable, save upon such grounds as exist at law or in equity for the revocation of any contract."<sup>33</sup> Section 2 applies in state court and preempts conflicting state laws, including state franchise laws.

In Southland Corp. v. Keating,<sup>34</sup> the franchisees sued 7-Eleven for violation of the California franchise laws, among other claims. 7-Eleven moved to compel arbitration under the franchise agreement. The California Supreme Court held that the arbitration agreement was unenforceable because it was an invalid "condition, stipulation or provision purporting . . . to waive compliance with any provision of [the California franchise law]." The United States Supreme Court reversed the California Supreme Court, holding that the FAA applied in state court and preempted the California ant-waiver provision as applied to arbitration clauses.

To avoid FAA preemption, courts will rely on the "save upon such grounds as exist in law or in equity for the revocation of any contract" language of Section 2. For example, in Aral v. Earthlink, Inc.,<sup>35</sup> a California court recently held that a requirement that a California consumer arbitrate in Georgia was unconscionable, stating "a forum selection clause that discourages legitimate claims by imposing unreasonable geographical barriers is unenforceable under well-settled California law." The court decided that whether the forum selection clause was unconscionable was a "gateway" issue for the court, not the arbitrator, thereby avoiding FAA preemption. The Court in Aral, relied upon Green Tree Financial Corp. v. Bazzle for the proposition that courts are to determine certain "gateway" matters, such as the validity and scope of the arbitration agreement,<sup>36</sup> and Discover Bank v. Superior Court for the proposition that under California law, the question of whether grounds exist for the revocation of the arbitration agreement based on grounds that exist for the revocation of any contract (including unconscionability and contrariness to public policy) is such a "gateway" matter for the courts to decide.<sup>37</sup> It is notable that Aral was a consumer case, arguable different than arbitration in a commercial context such as franchising.

In the U.S. Supreme Court's most recent decision on arbitration and FAA preemption, the Court held that an arbitration provision was enforceable even if the contract as a whole was illegal under state law as usurious.<sup>38</sup> Justice Scalia, writing for the Court, reasoned that regardless of whether the action is brought in federal or state court, a challenge to the validity of

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<sup>33</sup> 9 U.S.C. § 2.

<sup>34</sup> 465 U.S. 1 (1984).

<sup>35</sup> 134 Cal.App.4th 544 (2005).

<sup>36</sup> 539 U.S. 444 (2003).

<sup>37</sup> 39 Cal.4th 148 (2005).

<sup>38</sup> Buckeye Check Cashing, Inc. v. Cardegna, 2006 U.S. LEXIS 1814 (Feb. 21, 2006).

a contract as a whole, and not specifically to the arbitration clause within it, must go to the arbitrator, not the court.

Arbitration was successfully compelled in Jensen v. Quik International,<sup>39</sup> even though the franchisor allowed its registration with Illinois state authorities to lapse just before signing the franchise agreement containing the arbitration provision. When the franchisee sought to rescind the franchise agreement, the franchisor moved to compel arbitration, and the franchisee argued that the arbitration provision of the franchise agreement was not enforceable because the franchisor was not registered as a franchise in Illinois when the franchise agreement was executed. The Court held that the provision was enforceable, that the legislature had not intended registration to be a condition precedent to an enforceable franchise agreement.

### **b. Forum Selection**

When determining the enforceability of a forum selection clause in a franchise agreement, there is an important distinction between judicial forum selection clauses and arbitral forum selection clauses: Judicial forum selection clauses are generally enforceable unless state franchise law is to the contrary.<sup>40</sup> Arbitral forum selection clauses are generally enforceable and any contrary state law is preempted by the FAA.

Judicial forum selection clauses in the following states will not be enforced to require a franchisee to litigate outside the franchisee's home state: California, Connecticut, Illinois, Indiana, Iowa, Louisiana, Maryland, Michigan, Minnesota, New Jersey, North Carolina, North Dakota, Rhode Island, South Carolina, and Wisconsin. In a case involving the California statute, the Ninth Circuit rejected a franchisor's claim that the franchise agreement's provision for a Pennsylvania forum prevented the California franchisee from suing in California.<sup>41</sup>

In the absence of a statutory restriction, judicial forum selection clauses are otherwise "presumptively valid" and should be "specifically" enforced unless the resisting party "could clearly show that enforcement would be unreasonable and unjust, or that the clause was invalid for such reasons as fraud and overreaching."<sup>42</sup> In order to demonstrate unreasonableness, the challenging party must show that "trial will be so gravely difficult and inconvenient that [the party seeking a different forum] will for all practical purposes be deprived of his day in court."<sup>43</sup>

Assuming that the franchise agreement is not unconscionable, arbitral forum selection clauses are generally enforceable, notwithstanding state statutes which could be read to limit

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<sup>39</sup> 820 N.E.2d 462 (Ill. 2004).

<sup>40</sup> The Bremen v. Zapata Off-Shore Co., 407 U.S. 1 (1972) (holding that forum selection clauses are "presumptively valid").

<sup>41</sup> Jones v. GNC Franchising, Inc., 211 F.3d 495 (9th Cir. 2000). See also Kubis & Perszyk Assoc., Inc. v. Sun Microsystems, Inc., 680 A.2d 618 (N.J. 1996) (held enforcement of forum-selection clauses in franchise agreement undermined protections of the N.J. franchise law and were presumptively invalid).

<sup>42</sup> See The Bremen.

<sup>43</sup> *Id.*

them, because these statutes are preempted by the FAA. In Bradley v. Harris Research, Inc.,<sup>44</sup> a California franchisee sought to invalidate a franchise agreement provision requiring arbitration in Utah. In reversing the district court, the Ninth Circuit required the California franchisee to arbitrate in Utah. Even though (1) the franchisee had signed the franchise agreement under protest, asserting that it was a contract of adhesion and lacked mutuality, and (2) California franchise law provides that “a provision in a franchise agreement restricting venue to a forum outside this state is void,” the Ninth Circuit found that the arbitration agreement was binding and that the arbitration should take place in Utah because the FAA preempted the California franchise law. The franchisees did not raise unconscionability on appeal. *See also* Doctor’s Assoc., Inc. v. Hamilton,<sup>45</sup> OPE Int’l LP v. Chet Morrison Contractors, Inc.<sup>46</sup>

Other recent decisions suggest, however, that franchisees may be able to avoid arbitration in distant venues by arguing that venue provisions are unconscionable.<sup>47</sup>

### c. Choice of Law

Most states follow the Restatement position that choice of law provisions should be honored unless:

(A) (1) there is no substantial relationship between the state and (a) the parties or (b) the transaction, and (2) there is no other rational reason for choosing the law of the state, or

(B) using the law of the chosen state would be contrary to a fundamental policy of (1) a state that has a materially greater interest in the matter, or (2) a state whose law would apply in the absence of the choice of law provision.

Restatement (Second) of Conflicts § 187.

The Court in Ticknor v. Choice Hotels Int’l, Inc.<sup>48</sup> applied the Restatement test in accordance with Montana law and refused to enforce a choice of law provision in favor of Maryland because the Court found the contract as a whole to be a contract of adhesion.

However, even if the choice of law provision passes the Restatement test, several states with franchise disclosure and franchise relationship laws have anti-waiver provisions to insure that franchisees residing or operating in the state have the protection afforded by that state’s law. Notwithstanding these anti-waiver provisions, in a case involving a California franchisor and a Pennsylvania franchisee, the Court held that the California franchise laws did not void a choice

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<sup>44</sup> 275 F.3d 884 (9th Cir. 2001).

<sup>45</sup> 150 F.3d 157 (2nd Cir. 1998) (N.J. franchise law preempted by FAA).

<sup>46</sup> 258 F.3d 443 (5th Cir. 2001) (Louisiana franchise law preempted by FAA).

<sup>47</sup> *See, e.g.,* Ticknor v. Choice Hotels Int’l, Inc., 265 F.3d 931 (9th Cir. 2001) (franchise agreement’s arbitration provision requiring arbitration in Maryland under Maryland law held unconscionable under Montana law and not preempted by the FAA); Bolter v. Superior Court, 87 Cal. App.4th 900 (2001) (court struck part of arbitration provision which required arbitration in Utah because it was unconscionable and not preempted by the FAA).

<sup>48</sup> 265 F.3d 931 (9th Cir. 2001).

of law provision in favor of Pennsylvania law with respect to claims of fraud and negligent misrepresentation in connection with the sale of a franchise.<sup>49</sup>

**d. Waiver of Class-Wide Relief**

Recently, in Independent Association of Mailbox Center Owners, Inc. v. Superior Court,<sup>50</sup> franchisees of Mail Boxes, Etc. sought to pursue claims on a classwide basis based upon the forced conversion of their stores to a new format (UPS Stores) after the acquisition of the franchisor by UPS. The franchise agreement for many of the franchisees contained a clause banning classwide arbitration. Finding that franchise agreements can have some characteristics of contracts of adhesion, and their provisions can be examined to see if they contain provisions that are unconscionable, the court refused to enforce a class action waiver it found to be adhesive and unconscionable. (The court also found that a class was appropriate even though there were three separate forms of contracts involved and that there were “difficult issues” remaining regarding “separating out the common issues of law and fact ... from the individualized ... issues.”) See also Discover Bank, supra, (holding that “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”);<sup>51</sup> Aral, supra, (holding that ban on class-wide arbitration held unconscionable).<sup>52</sup>

**e. Jury Trial Waiver**

The right to a jury trial is waivable in federal courts and in all states but Georgia, Minnesota and California.<sup>53</sup> Any waiver of a jury trial, however, must be conspicuous.<sup>54</sup>

**f. Punitive Damages Waiver**

Courts are divided on whether or not punitive damages may be waived.

California courts have deemed such waivers of punitive damages and other remedies to be unenforceable. As stated by the court in Independent Association of Mailbox Center Owners, supra, “to the extent that the arbitration clauses ... seek to deprive the claimants of statutorily authorized remedies [including punitive damages], or relief a court would otherwise be allowable to them, they are unconscionable, and the trial court should have stricken them from the

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<sup>49</sup> Cottman Transmission Sys., Inc. v. Melody, 869 F. Supp. 1180 (E.D. Pa. 1994).

<sup>50</sup> 133 Cal. App. 4<sup>th</sup> 396 (2005).

<sup>51</sup> 39 Cal. 4<sup>th</sup> 148 (2005).

<sup>52</sup> 134 Cal. App. 4<sup>th</sup> 544 (2005)

<sup>53</sup> See Bank South, N.A. v. Howard, 444 S.E.2d 799 (Ga. 1994); Minnesota Rules, 1995, Department of Commerce § 2860.4400.J; Grafton Partners L.P. v. Superior Court, 36 Cal.4<sup>th</sup> 944 (2005) (California Supreme Court unanimously decided that a pre-dispute jury trial waiver in a contract between an accounting firm and its client was unenforceable because it violated the state constitution). Cf. AAMCO Transmissions v. Harris, 1990 U.S. Dist. LEXIS 7387 (E.D. Pa. 1990) (jury waiver enforced in litigation between franchisee and franchisor).

<sup>54</sup> Westide-Marrero Jeep Eagle, Inc. v. Chrysler Corp., CCH Bus. Franchise Guide ¶ 11,710 (E.D. La. 1999) (waiver in franchise agreement just above signature block held enforceable).

arbitration clause.” *But see Bolter v. Superior Court*, in which the court did not strike the waiver of punitive damages, although it had relied on, among other things, the punitive damages waiver to find the arbitral forum selection clause unconscionable.<sup>55</sup>

Some are in accord, and others are not.<sup>56</sup> Some statutes expressly prohibit waivers of punitive damages. Most notably perhaps, the Petroleum Marketing Practices Act (“PMPA”) expressly prohibits the waiver of any rights under the law.<sup>57</sup>

### **g. Provisions re: Time Limitations on Claims**

As a general rule, courts allow parties to agree on shorter limitations periods than those prescribed by statute, as long as the shorter periods are reasonable.<sup>58</sup> A shortened limitations period is unreasonable if it is so short that it effectively prevents lawsuits.<sup>59</sup> Also, a shortened limitations period has been held to be unreasonable where it benefits only one party.<sup>60</sup> However, at least one court has enforced a limitations period that limited only claims of the franchisee.<sup>61</sup>

Some states and federal statutes have statutory bars on changing the limitations period where the shorter period restricts the ability to enforce any rights through a legal proceeding.<sup>62</sup> Maryland law specifically prohibits shorter limitation periods for claims brought under franchise and unfair competition laws.<sup>63</sup> Similarly, the parties cannot agree to a shortened limitations period that would effectively waive provisions of the PMPA.<sup>64</sup>

## **3. Suggested Ways to Address Dispute Resolution Issues**

### **a. Three Step Process**

One way to try to resolve disputes is a provision for a three-step process employed in a number of franchise agreements. Under this provision, the parties must engage in a face-to-face meeting and then participate in mediation, prior to engaging in arbitration. Obviously, however, this could create problems in terms of a speedy resolution of a matter. Therefore, it is important

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<sup>55</sup> 87 Cal.App.4th 900 (2001).

<sup>56</sup> *See, e.g., Ex Parte Thicklin*, 824 So.2d 723 (Ala. 2002) (Alabama Supreme Court finds punitive damages waiver to be unconscionable); *Sanderson Farms, Inc. v. Gatlin*, 848 So.2d 828 (Miss. 2003) (Mississippi Supreme Court holds punitive damages waiver to be enforceable).

<sup>57</sup> 15 U.S.C. § 2805(f). *See, e.g., Graham Oil Co. v. ARCO Products Co.*, 43 F.3d 1244 (9th Cir. 1995).

<sup>58</sup> *Tupper v. Bally Total Fitness Holding Corp.*, 186 F. Supp. 2d 981 (E.D. Wis. 2002).

<sup>59</sup> *Northlake Reg'l Medical Center v. Waffle House Sys. Emp. Benefit Plan*, 160 F.3d 1301 (11<sup>th</sup> Cir. 1998).

<sup>60</sup> *Burroughs Corp. v. Suntogs of Miami, Inc.*, 472 So.2d 1166 (Fla. 1985).

<sup>61</sup> *Thabet v. Mobil Corporation*, CCH Business Franchise Guide ¶ 12,612 (Cal. App. 2003).

<sup>62</sup> Idaho Code § 29-110(1); *Sheehan v. Norris Irrigation*, 410 N.W.2d 569 (S.D. 1987) (applying South Dakota law).

<sup>63</sup> *D&K Foods, Inc. v. Bruegger's Corp.*, Bus. Franchise Guide (CCH) ¶ 11,506 (D. Md. 1998).

<sup>64</sup> *Graham Oil Co. v. ARCO Products Co.*, 43 F.3d 1244 (9th Cir. 1995) (cannot reduce one-year statute of limitations to 90 days).

that the franchise agreement state that a demand for arbitration may filed prior to, or during the pendency of, the face-to-face meeting and mediation. It should also state that these procedures are to take place as soon as possible after the filing. To avoid delay, strict time limits should be set forth as well for the selection or appointment of the arbitrator and for the actual completion of the arbitration. The franchise agreement should make clear that the mediation and the arbitration may proceed on parallel tracks to avoid unnecessary delay. Following is an example for such a provision:

- Claim Process. Any litigation, claim, dispute, suit, action, controversy or claim ("claim") between or involving you and us, based on whatever theory and/or facts, and whether or not arising out of this Agreement, will be processed in the following manner, except as expressly provided be at [section or paragraph re: injunctive relief carve-out].
- First, discussed in a face-to-face meeting held within thirty (30) days after either you or we give written notice to the other proposing such a meeting.
- Second, if not resolved, submitted to non-binding mediation for a minimum of eight (8) hours before (i) Franchise Arbitration and Mediation, Inc. ("FAM") or its successor (or an organization designated by FAM or its successor), or (ii) another mediation organization approved by all parties, or (iii) by Judicial Arbitration and Mediation Service ("JAMS") or its successor (or an organization designated by JAMS or its successor) if FAM cannot conduct such mediation and the parties cannot agree on a mediation organization. Any mediation will be conducted by a mediator experienced in franchising. Any party may be represented by counsel and may, with the permission of the mediator, bring persons appropriate to the proceeding. If both you and we do not want to participate in mediation, you and we may proceed to arbitration as provided below.
- Third, submitted to and finally resolved by binding arbitration before and in accordance with the arbitration rules of FAM or its successor (or an organization designated by FAM or its successor); provided such that if arbitration is unable to be heard by any such organization(s), then the arbitration will be conducted before and in accordance with the arbitration rules of JAMS or its successor (or an organization designated by JAMS or its successor). The arbitrator shall be experienced in franchising, and if the parties cannot agree on the arbitrator within thirty (30) days of commencement of the arbitration, then the arbitrator shall be selected solely and exclusively by the arbitration organization. On election by any party, arbitration and/or any other remedy allowed by this Agreement may be commenced prior to, or during the pendency of, the face-to-face meeting and/or the mediation process. The face-to-face meeting and/or the mediation process are to take place as soon as possible after the commencement of the arbitration. In other words, the face-to-face meeting and/or mediation and the arbitration may proceed on parallel tracks for the purpose of avoiding any delay. Judgment on any preliminary or final arbitration award shall be final and binding, and may be entered in any court having jurisdiction (subject to the opportunity for appeal as discussed below).
- Fourth, a final award by an arbitrator (there will be no appeal of interim awards or other interim relief) may be appealed within thirty (30) days of such final award. Appeals will be

conducted before a three (3) arbitrator panel appointed by the same organization which conducted the arbitration, each member of which shall be experienced in franchising. The arbitration panel will not conduct any trial de novo or engage in any fact-finding function. Such panel's decision may be entered in any court having jurisdiction and will be binding, final and non-appealable.

**b. Selection of Arbitrator / Rules in Arbitration**

Franchise agreements should be very clear as to the organization which will conduct the arbitration (*e.g.*, AAA, FAM, JAMS, etc.). There are many well-respected ADR organizations. However, each has its own rules and procedures (for example, as to the scope of discovery). Accordingly, consideration should be given as to the rules to be followed when selecting the organization.

As for particular arbitrators, it is helpful for a number of reasons if the arbitrator(s) are knowledgeable regarding franchise law. Therefore, a provision requiring that the arbitrators have a certain experience level in franchise law may be desirable (*e.g.*, an attorney with X years experience, with his/her practice for the last Y years comprised at least 50% on franchise matters). One potential problem with including such a requirement is that (depending on the amount of experience that is required) the potential pool of arbitrators may be relatively limited as a result, which could lead to delay.

**c. Rules re: Discovery in Arbitration**

While each ADR organization has its own rules, the franchise agreement may be used to modify the rules which are not desired, and it should in any event identify the rules on discovery. For example, the agreement may place limits on the scope of written discovery (*e.g.*, document production demands only), the number of depositions, and the length of any depositions (such as the current seven hour limit in federal court).

A limitation on discovery that franchisors should consider strongly is that discovery may be had as to the relationship between the franchisor and the particular franchisee only, and as to no other franchisee. Such a limitation will not only limit the scope (and cost) of the arbitration, it will also prevent fishing expeditions by attorneys.

**d. Equitable Relief Carve-Out**

Even if a franchisor deems arbitration to be generally desirable, there are situations where arbitration will not enable the franchisor to obtain relief. The most obvious such situation is where the franchisor is seeking injunctive relief on an emergency basis. Accordingly, the arbitration provision in the franchise agreement should provide that the parties may seek injunctive relief through the court system. For example:

- Injunctive Relief. Notwithstanding the arbitration provisions above, Franchisor may bring an action in any court of competent jurisdiction for injunctive or extraordinary relief, without the necessity of posting any bond, as Franchisor deems necessary or appropriate (i) with

respect to violations of the Franchisee's obligations under [*e.g.*, in-term covenant not to compete], or (ii) with respect to the use or display of the [Brand or Trademark, as defined in the franchise agreement], or (iii) to otherwise compel Franchisee to take steps reasonably necessary to preserve the Franchisor's reputation, goodwill and/or proprietary rights. Franchisee acknowledges that Franchisee is one of a number of licensed franchisees using the Brand and that failure on Franchisee's part to comply fully with any of the terms of this Agreement with respect to the foregoing obligations regarding examinations, audits and the [Brand or Trademark] could cause irreparable damage to Franchisor and its other franchisees. Therefore, Franchisor shall have the immediate right to seek a preliminary order or injunction enforcing the foregoing obligations during the pendency of mediation, arbitration or other proceedings, without the necessity of Franchisor posting a bond. This covenant is independent, severable and enforceable, notwithstanding any other rights or remedies Franchisor may have.

#### **e. Forum Selection**

To the extent that they are otherwise enforceable (see above), franchisors should anticipate that franchisees will argue that forum selection provisions that require them to arbitrate in an inconvenient location are unconscionable. Thus, these provisions should be conspicuous in any agreement to enhance the chances that they will be enforced. Having the Franchisee initial this, and other clauses likely to be challenged, may be a wise practice.

Any venue provision should include a provision barring the use of the forum state's conflict of laws rules to conclude that the matter should be heard in the home state of the franchisee.

#### **f. Choice of Law**

As noted above, most states will honor choice of law provisions in most circumstances. To increase the chances that the provision will be honored, it may be helpful to include language in the franchise agreement that the parties recognize that certainty as to the law to be applied to their relationships is important to their ability to conduct ongoing business, and that the parties have agreed that a particular state's law shall apply to any dispute between them related to the franchise relationship. To ensure that the franchisor can invoke the Lanham Act for pursuing claims under the Act for trademark infringement and unfair competition, the agreement should likely state that the state's law does not apply to the extent that the Lanham Act applies.

As discussed above, there will likely be situations where a franchisor does not want a particular state's law to apply (*e.g.*, California law on covenants not to compete or jury waivers). The franchise agreement should state that the law to be applied is that of a particular state, except for provisions deemed to be unenforceable under the law of that state, in which case the law of another state (perhaps the state where the franchisee is located or does the bulk of its business) shall apply. For example:

- You and we agree on the practical business importance of certainty as to the law applicable to your and our relationship and its possible effect on the development and the competitive

position of the System. Therefore, you and we also agree that, except with respect to the applicable of the Federal Arbitration Act, 9 U.S.C. § 1 *et seq.* (the "FAA") and the effect of federal preemption of state law by the FAA, and except to the extent governed by the Lanham Act and other federal laws and as otherwise expressly provided in this Agreement, this Agreement and all other matters, including, but not limited to, respective rights and obligations, concerning you and us, will be governed by, and construed and enforced in accordance with, the laws of the state where the largest geographic portion of your Area is located. You and we agree that this provision shall be enforced without regard to the laws of such state relating to conflicts or choice of laws; except that the provisions of any law of that state regarding franchises (including but not limited to registration, disclosure, and/or franchise relationship) shall not apply unless such state's jurisdictional, definitional and other requirements are met independently of, and without reference to, this Section.

**g. Mutuality**

For all arbitration and other pre-dispute provisions that do not provide for mutual obligations, or are designed to be more restrictive to the franchisee than the franchisor, there is a real risk that such provisions may be invalidated. In fact, a non-mutual provision (*e.g.*, a non-mutual waiver) could jeopardize the entire arbitration agreement. Accordingly, the franchisor should strongly consider making all such provisions mutual.

**h. Waiver of Rights**

To the extent they are otherwise enforceable (see above), franchisors should anticipate that waivers such as jury trial, punitive damages and class action waivers will be attacked as unconscionable. Therefore, waiver language must be conspicuous. Requiring the franchisee to initial or otherwise acknowledge these waivers should increase the chances that they will be deemed enforceable (assuming they are not barred by statute (see above)).

As with almost any provision of the agreement, it is important that waivers be easily severed from the rest of the agreement to avoid a court ruling the entire agreement to be so infected that it is discarded in its totality. In that regard, the franchise agreement should also have a provision explicitly stating that, if any provision of the agreement is deemed to be unenforceable, it shall be modified to the extent possible under law, and that the unenforceability of the provision shall have no effect upon the rest of the agreement.

Franchisors should consider carve-outs to any waivers. For example, a franchisor may wish to pursue punitive damages in actions over trademark infringement, misappropriation of trade secrets, and indemnity provisions (*i.e.*, to ensure that a franchisee must indemnify the franchisor for any punitive damages award related to the franchisee). Thus, the punitive damages waiver could provide an exception for these types of actions.

**i. Provisions re: Damages Limitations**

In addition to provisions waiving punitive damages, the franchise agreement may place a cap on damages under which the total liability of the parties to each other relating to the franchise agreement in any way shall be no greater than a certain number.

**j. Provisions re: Time Limitations on Claims**

As noted above, contractual limitations periods are generally upheld by the courts, if they are not too short (such as 90 days) or unilateral. The limitations provision in the franchise agreement should anticipate that the franchisee will seek to expand the time period to bring a claim by invoking the discovery rule (i.e., that the limitations period does not run until the claimant discovered the facts giving rise to the claim or should have discovered the facts in the exercise of reasonable diligence). Therefore, the contractual limitations period provision should not only set out a traditional limitations period, but also should explicitly place an outside limit on the time period for bringing claims which runs from the date of the occurrence of the acts/omissions which give rise to the claim (much like a statute of repose). Obviously, franchisees could use such a provision to seek to avoid the payment of fees. Therefore, franchisors may wish to consider carving out from any shortened limitations claims against franchisees for the payment of ongoing fees where franchisees have misreported information.

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James Mulcahy, of The Mulcahy Law Firm, specializes in franchise and distribution, antitrust / competition and related intellectual property litigation. The Mulcahy Law Firm represents manufacturers and franchisors in their dealings with competitors, franchisees, distributors, dealers, suppliers, government agencies and others. In addition, Mr. Mulcahy litigates and counsels clients concerning California's Cartwright Act and Unfair Competition Act, as well as the federal Sherman, Clayton and Robinson-Patman Acts.

Mr. Mulcahy has been active for a number of years in various bar organizations. He currently serves as Co-Chair of the Franchise Law Committee, and is also a member of the Los Angeles, Orange County, and American Bar Associations (*Distribution and Franchising Committee, Antitrust Law Section and Forum on Franchising*).

Mr. Mulcahy speaks regularly before bar and business organizations on topics of franchise and distribution law. He has authored or co-authored a number of legal articles and publications on franchise and other methods of distribution. His articles published in 2006 include: Franchise Agreement Drafting – Basic Tracks as part of the International Franchise Association's Annual Symposium in May 2006; and Recent Decisions and Legislation: California Franchise and Distribution published in the June 2006 edition of Business Law News for the California State Bar, Business Law Section. Mr. Mulcahy is also a contributing author of the chapter on tying arrangements in Antitrust Law and Economics of Product Distribution, published in 2006 by the American Bar Association, Antitrust Law Section.

Mr. Mulcahy's previous publications include: Exclusive Distributorships and Dual Distribution: How to Avoid Dealer Litigation, which appeared in the November 2002 issue of the Orange County California Lawyer; Current Developments in Franchise Law for the Business Law Section, Franchise Law Committee, California State Bar Association in March 2003; Hot Topics in Franchise Litigation as part of the California State Bar's 77th Annual Meetings in September 2004; and Hot Topics in Franchise Litigation as part of the California State Bar's 78th Annual Meetings in September 2005.

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