LITIGATION ABOUT ARBITRATION

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I. INTRODUCTION

At the beginning of the twentieth century there was a strong judicial aversion to arbitration as a method of dispute resolution. The judiciary’s approach to arbitration changed in 1923 with enactment of the Federal Arbitration Act (the “FAA”). The FAA embodies a strong national policy favoring arbitration, most federal and state courts are now viewed as pro-arbitration and courts have “liberally” applied the FAA in deciding whether a matter should be arbitrated.

Today, a substantial percentage of franchise agreements contain dispute resolution provisions requiring arbitration. In theory, a franchise agreement arbitration clause keeps the parties out of court. Often, however, disputes over the need or method of arbitration arise and, with the increased use of arbitration provisions, litigation about arbitration has become commonplace.

This paper and the accompanying workshop focus on litigation about arbitration. The paper begins with a brief history of arbitration and an overview of the conflicting perspectives of franchisors and franchisees toward arbitration. The tension between these competing perspectives helps to explain, in part, why franchise litigation over arbitration has become so prevalent today. The paper then discusses the types of issues that may be arbitrated and addresses whether a court or an arbitration panel initially should determine what disputes are subject to arbitration. The paper also addresses the legal issues involved in applications to avoid arbitration, the bases upon which arbitration provisions can be attacked, whether non-signatories to a franchise agreement containing an arbitration clause can be compelled to arbitrate, and whether non-signatories can compel arbitration. In addition, the paper reviews class action and consolidation issues as they arise in arbitration, the use of the judicial system for injunctive relief outside the arbitration process, and the procedure for obtaining injunctions from arbitrators. Finally, the paper explores the issues involved in confirming and vacating an arbitration award.

* This paper represents the collective work of its authors. However, given the nature of the topic and its treatment, as well as the desire to analyze the topic in a unified paper, any particular views expressed herein do not necessarily represent the individual views of the authors or their respective law firms or partners.

1. *Buckeye Check Cashing, Inc. v. Cardegna*, 126 S.Ct. 1204, 1207, 163 L.Ed. 1083 (2006) (stating “[t]o overcome judicial resistance to arbitration, Congress enacted the Federal Arbitration Act (FAA), 9 U.S.C §§ 1-16. Section 2 embodies the national policy favoring arbitration and places arbitration on equal footing with all other contracts...”).

2. Annual Franchise and Distribution Law Developments 2005, p. 255 (stating “this year’s cases illustrate that this pro-arbitration approach to contract construction generally continues in state and federal courts.”)

3. S. McInnis, *Enforcing Arbitration with a Nonsignatory: Equitable Estoppel and Defensive Piercing the Corporate Veil* 1995 J.DISp RESOL 197. (“Since congress enacted the FAA, courts have liberally enforced a strong national policy favoring arbitration of commercial disputes.”)

4. One study found that approximately forty five percent (45%) of the surveyed franchise agreements registered in the state of Minnesota contained arbitration provisions. C. Drahozal, *Arbitration Clauses in Franchise Agreements: Common (and Uncommon) Terms*, 22 FRANCHISE L.J. 81 (FALL 2002).
A. The Franchisee Perspective on Arbitration

Although much of the franchise litigation related to arbitration reflects franchisees’ disdain for arbitration as a method of dispute resolution, there are, as is usually the case, two sides to every story: there are both pros and cons to arbitration even from a franchisee perspective.

Perhaps the most significant reasons that many franchisees and their advocates dislike arbitration are the lack of jury trials and the limited judicial review of arbitration awards. Most franchisees believe that a jury will be more sympathetic to their story. Juries, which tend to consist of people who can relate to the entrepreneurial efforts of franchisees, are likely to award higher amounts for damages than are arbitrators. Arbitrators, particularly those with big firm backgrounds, tend to relate more readily to franchisors. An additional disadvantage is that an arbitrator’s determination is not appealable; a party’s only recourse is to move to vacate the award. As described in greater detail below, arbitration awards receive great judicial deference and are extremely difficult to vacate. Therefore, if an arbitrator rejects a franchisee’s claims that is usually the end of the story.

The cost of arbitration is also a substantial negative factor from a franchisee’s perspective. Historically, franchisees viewed arbitration as a forum for airing their grievances that would not break the bank. Today, many franchisee advocates believe that conducting an arbitration to conclusion can cost as much, if not more, than litigation. The reasons for the high costs of arbitration are:

(1) the filing fees required by the arbitration tribunals;

(2) the fees paid to arbitrators; and

(3) the now liberal and expansive use of arbitration discovery and motion practice.

The cost to file a case in federal court is $350, no matter what the amount in controversy. Filing fees in arbitration are much larger. The American Arbitration Association’s (“AAA”) filing fee for a case claiming up to $10,000 in damages is $750 plus a $200 case service fee.5 For a case seeking recovery of $500,000 to $1,000,000, a fairly typical damage

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5 The current fees for filing a commercial arbitration with the AAA, listed on its website, are as follows:

An initial filing fee is payable in full by a filing party when a claim, counterclaim or additional claim is filed. A case service fee will be incurred for all cases that proceed to their first hearing. This fee will be payable in advance at the time that the first hearing is scheduled. This fee will be refunded at the conclusion of the case if no hearings have occurred. However, if the Association is not notified at least 24 hours before the time of the scheduled hearing, the case service fee will remain due and will not be refunded.

These fees will be billed in accordance with the following schedule:

<table>
<thead>
<tr>
<th>Amount of Claim</th>
<th>Initial Filing Fee</th>
<th>Case Service Fee</th>
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<tbody>
<tr>
<td>Above $0 to $10,000</td>
<td>$750</td>
<td>$200</td>
</tr>
<tr>
<td>Above $10,000 to $75,000</td>
<td>$950</td>
<td>$300</td>
</tr>
<tr>
<td>Above $75,000 to $150,000</td>
<td>$1,800</td>
<td>$750</td>
</tr>
<tr>
<td>Above $150,000 to $300,000</td>
<td>$2,750</td>
<td>$1,250</td>
</tr>
<tr>
<td>Above $300,000 to $500,000</td>
<td>$4,250</td>
<td>$1,750</td>
</tr>
</tbody>
</table>
range in a franchise dispute, the filing fee is $6,000, plus a $2,500 case service fee, for a total of $8,500. This is approximately twenty-five (25) times the cost for filing the same claim in federal court. It is easy to see why commentators argue that the filing fees are a deterrent to arbitration.\(^6\)

Of course, the filing and case service fees are not the only costs of arbitration. In court cases, taxpayers pay the cost associated with the judge and jury. In arbitration, the parties pay the arbitrator or arbitrators at rates of several hundred dollars per hour, which in a complex case can easily total six figures. A case that takes five days to try before a three-arbitrator panel (at $400 per hour, per arbitrator) costs the parties approximately $50,000 just for the hearing. When time is added for all the pre-hearing discovery disputes and motion practice, arbitration fees can quickly deplete the resources of a franchisee. Obviously, another component of the cost of arbitration is the fees paid to the franchisee’s attorney. When arbitrations were handled more expeditiously, the fees were lower, and at least one of the benefits of arbitration, cost-saving, was realized. Unfortunately, attorneys’ fees for franchisees have risen dramatically as the time spent on discovery and motion practice has expanded.

Many members of the franchisee bar dislike arbitration because of the ever expansive role of discovery and motion practice, which is the norm in today’s arbitrations. As originally conceived, arbitration was a faster method of dispute resolution than litigation. However, where arbitrators allow large scale discovery and routinely entertain motions, speed of resolution cannot necessarily be counted on as a benefit of arbitration.\(^7\) Indeed, discovery and motion

<table>
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<tr>
<th>Claim Size</th>
<th>Fee</th>
<th>Case Service Fee</th>
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<tbody>
<tr>
<td>Above $500,000 to $1,000,000</td>
<td>$6,000</td>
<td>$2,500</td>
</tr>
<tr>
<td>Above $1,000,000 to $5,000,000</td>
<td>$8,000</td>
<td>$3,250</td>
</tr>
<tr>
<td>Above $5,000,000 to $10,000,000</td>
<td>$10,000</td>
<td>$4,000</td>
</tr>
<tr>
<td>Above $10,000,000</td>
<td>*</td>
<td>*</td>
</tr>
<tr>
<td>Nonmonetary Claims**</td>
<td>$3,250</td>
<td>$1,250</td>
</tr>
</tbody>
</table>

Fee Schedule for Claims in Excess of $10 Million

The following is the fee schedule for use in disputes involving claims in excess of $10 million. If you have any questions, please consult your local AAA office or case management center.


\(^6\) Jennifer L. Gehrig, *Arbitration: A Franchisee’s Perspective*, 22 FRANCHISE L.J. 121 (Fall 2002) (stating that “...the initial expense of instituting an arbitration proceeding can be prohibitive.”) In addition, Ms. Gehrig labels the filing fee in commencing an arbitration as the “first major hurdle for most franchisees” in attempting to make arbitration “roughly comparable” to judicial resolution. *Id.*

\(^7\) Bethany L. Appleby, *Interim Relief: Preserving Goodwill During Termination Proceedings*, 22 FRANCHISE L.J. 125 (Fall 2002) (“Arbitrations can drag on for many months, even years, while the parties deal with assorted legal, procedural, scheduling, and discovery issues, which become even
practice within an arbitration can delay the resolution of disputes in the same way that discovery and motion practice delay a case in court.

Some franchisees and practitioners who represent them view arbitration in a more positive light. In general, arbitrations are still resolved more quickly than litigation. In fact, it is not unusual to complete an arbitration proceeding where there is limited discovery and motion practice within six to nine months, while a comparable dispute in court can take far longer to reach a verdict. To some, another attribute of arbitration is that in most cases, the award produces finality, which has a value. Certain franchisee attorneys view the arbitration process positively because of the relaxed rules of evidence, allowing parties to introduce testimony or documents that would not see the light of day in court. For example, an arbitrator may be willing to hear the testimony of non-party franchisees who claim, like the party franchisee, to have been induced to enter into an agreement based upon earnings claims or other misrepresentations. In court, such testimony may not be allowed. Additionally, arbitrators may be willing to accept a witness affidavit or telephonic appearance in lieu of in person testimony. In court, witnesses must generally appear in person.

Arbitration also can be viewed as helping to reduce costs in a few ways. First, in court actions, there are many times when an attorney may be found sitting and waiting for a conference or hearing. On the other hand, arbitrations frequently have preliminary conferences via telephone and hearings on dates certain, thus dramatically reducing the potential for unnecessary preparation or courtroom appearance time. Second, franchise disputes are often resolved in the franchisor’s home state. If the franchisee’s lead counsel is from outside that jurisdiction, local counsel will have to be retained on behalf of the franchisee if the matter is pending in court. In an arbitration, except in rare circumstances, such as arbitrations in California, it is not necessary for an out-of-state attorney to engage local counsel in order to participate in an arbitration.

Limited discovery can be another positive attribute of arbitration. While discovery in arbitration today is typically more expansive than it has been in the past, depositions, which are one of the costliest discovery devices, are the exception rather than the norm. Additionally, as a whole, discovery in arbitration is less expensive than in a comparable lawsuit.

Finally, another attribute of arbitration from a franchisee’s perspective is that the arbitrator(s) have greater flexibility than a jury in awarding damages to a franchisee. Therefore, although an arbitrator may not grant the full amount sought, arbitrators may provide a portion of the recovery demanded, while a jury will often only award what is sought or nothing at all.

When the prospect of the jury is removed (for example, where the franchisee has waived a jury trial) and the remaining options are a bench trial or an arbitration, a franchisee’s preference with regard to dispute resolution is typically a function of the perceived cost and time for resolution. In evaluating these factors from the franchisee perspective, the particular arbitrator’s approach is critically important. When an arbitrator limits discovery and motion practice, the franchisee is more likely to come away with a positive view of arbitration. However, when an arbitrator entertains dispositive motions and allows expansive discovery, especially depositions, the franchisee’s view tends to be much more negative.

more complex and time consuming when the franchisee asserts counterclaims in the termination proceedings. In short, there are times when an arbitration takes longer than it should.”)
B. The Dualing Franchisor Perspectives on Arbitration

Responding to a court system that is perceived to be inefficient, unpredictable and skewed in favor of small business, consumers and plaintiffs’ attorneys, franchisors in ever increasing numbers have relied upon arbitration as their dispute resolution method of choice. In large part, the popularity of arbitration can be attributed to its reputation as a means to reduce the costs of resolving complex or repetitive litigation and to level an otherwise tilted, litigation playing field.

From a franchisor’s perspective, some of the perceived advantages of arbitration are:

1. the curtailment of class litigation, since class actions generally will not be heard by an arbitrator and most courts are unlikely to consider certifying classes if named plaintiffs’ claims are being arbitrated;  
2. the potential to save substantial legal fees and costs to resolve disputes, leading to greater control over corporate legal budgets;  
3. the potential for a more speedy resolution of disputes, especially compared to many state court jurisdictions;  
4. the elimination of irrational, biased jury verdicts and elected state court judges who may be beholden to the plaintiffs’ bar and/or local sympathies;  
5. the tempering of punitive and exemplary damages claims;  
6. uniformity of arbitration procedures and forms nationwide, as opposed to fifty (50) different state codes, federal district and appellate court rules and countless local procedures;  
7. limited discovery; and  
8. limited ability to vacate arbitral awards.

At the same time, arbitration has its detractors in the franchisor bar. Some of the perceived disadvantages of arbitration to franchisors are:

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8 While the enactment of the Class Action Fairness Act of 2005 (“CAFA”) on February 18, 2005 has given some defense practitioners hope that class action exposure will be curtailed, CAFA’s full impact has not yet been proven. In enacting CAFA, Congress noted that abuses of the class action device have harmed class members with legitimate claims by limiting their recovery while awarding counsel large fees, harmed defendants that have acted responsibly, adversely affected interstate commerce, and undermined public respect for the judicial system. Class Action Fairness Act of 2005, Pub. L. No. 109-2, § 2, 119 Stat. 4 (2005). Nevertheless, many commentators believe the CAFA will lead to more (not less) class action litigation. Moreover, once initiated, class actions may become more (not less) difficult to settle. Accordingly, class action litigation continues to figure centrally in franchisor’s logic regarding arbitration. See generally Edward Wood Dunham and Michael J. Lockerby, Shall We Arbitrate? The Pros and Cons of Arbitrating Franchise Disputes, 28th Annual Forum on Franchising (2005), Lunch Programs, Tab L3, 38 (analyzing and considering litigation versus arbitration with regard to, among other things, class and consolidated proceedings).
(1) the filing fees and hearing costs are higher than court costs (although this is counter-balanced by savings of attorneys’ fees and the prospect of reduced fees applicable to “small claims” arbitrations);

(2) the difficulty of proceeding on an acceptable, net recovery basis against franchisees who refuse to participate meaningfully in the arbitration process, especially in small stakes collection cases;

(3) substantial preliminary litigation often occurs over the enforceability of arbitration clauses;

(4) franchisee attorneys or advocacy groups may try to portray a franchisor as overbearing because it is forcing franchisees to sign away their legal rights through a form “non-negotiable” contract;

(5) the lingering possibility of class arbitration. While the vast majority of the courts have held that class proceedings are not permitted in arbitration, some state courts (notably in California) have ordered class arbitrations;

(6) arbitrators have been observed to be reluctant to grant full relief in favor of either party and are widely perceived to “split the baby”;

(7) given federal docket management pressures, a United States District Court judge presented with a well-written contract is a better draw for a reputable franchisor than an arbitration panel;

(8) the inability of a franchisor to create a binding body of substantive legal precedent; and

(9) limited rights for judicial review.

On balance, there remains no right answer to the question whether arbitration is a more favorable dispute resolution method than litigation. In the end, each franchisor remains unique and must develop and implement dispute resolution procedures that make sense for its particular industry, financial circumstances and culture.

What is clear, however, is that franchisors face an increasingly complex web of applicable federal, state and local laws, rules and regulations. Within such an environment, arbitration should not be viewed mistakenly as a ticket to ignore one’s contractual and regulatory responsibilities. It is not. After all, an arbitration clause cannot be invoked against federal or state regulatory agencies, even when those agencies are seeking victim-specific relief. Perhaps more importantly, the prevailing winds of public opinion and recent expressions of judicial sensitivity discussed below suggest that, if franchisors behave unwisely in imposing onerous arbitration terms, a new day of legislative rigidity or judicial hostility toward arbitration could arrive.
II. A PRIMER ON ARBITRATION

A. What Law Applies to an Arbitration Clause in a Franchise Agreement?

As a starting point, a court hearing a dispute about arbitration must determine what law applies. The FAA governs all agreements to arbitrate contained in “a contract evidencing a transaction involving commerce.”9 Accordingly, absent the parties’ express agreement to the contrary, the FAA unquestionably applies to arbitration agreements involving franchised businesses.10

The FAA creates a body of federal substantive law that addresses arbitrability, applies to any arbitration agreement covered by the FAA, is enforceable in both state and federal courts and pre-empts any state law or policy to the contrary.11 For example, Section 2 of the FAA governs all questions of interpretation, construction, validity, revocability, and enforceability of arbitration agreements that are subject to the FAA. The FAA also establishes procedures for: (1) staying court actions; (2) appointing arbitrators; (3) compelling witnesses to attend an arbitration; (5) compelling arbitration; (6) confirming or vacating an arbitration award; and (7) appealing a court’s decision.12

B. Is the Application of the FAA Affected By a General State Choice-of-Law Provision?

The existence of a standard choice-of-law clause in a franchise agreement does not alter the “arbitrability” analysis under the FAA.13 The United States Supreme Court considered the interplay of an arbitration clause and a general choice-of-law provision in Mastrobuono v. Shearson Lehman Hutton, Inc.,14 and rejected the argument that a federal court should read a contract’s general choice-of-law provision as invoking state law on arbitrability and displacing federal arbitration law.15

The Mastrobuono choice-of-law provision specified that the “entire agreement” would “be governed by the laws of the State of New York.”16 The parties’ agreement provided: “This


13 Choice-of-law provisions embody the parties’ choice of one state’s laws over another’s, rather than express a preference between federal and state law. See Volt Info. Scis., Inc. v. Bd. of Trs. of Leland Stanford Junior Univ., 489 U.S. 468, 489-90, 109 S.Ct. 1248, 1261, 103 L.Ed.2d 488 (1989) (Brennan, J., dissenting) (“It seems to me beyond dispute that the normal purpose of such choice-of-law clauses is to determine that the law of one State rather than that of another State will be applicable; they simply do not speak to any interaction between state and federal law.”)


15 Id. 514 U.S. at 62.

16 Id. 514 U.S. at 58-59.
agreement ... shall be governed by the laws of the State of New York. Unless unenforceable due to federal or state law, any controversy arising out of or relating to [my] accounts ... shall be settled by arbitration...." The agreement contained no express reference to the availability of punitive damages. Under New York law, courts, but not arbitrators, could award punitive damages. The lower courts in Mastrobuono held that the contract’s broad choice-of-law provision was intended to invoke New York arbitration law – as well as New York substantive law – and that, as a result, the arbitrator had no power to award punitive damages.20

The Supreme Court reversed and held that the choice-of-law provision should be read, at most, to “include only New York’s substantive rights and obligations, and not the State’s allocation of power between [courts and arbitrators].” The court acknowledged that the provision’s phrase “New York law” could mean “New York decisional law, including that State’s allocation of power between courts and arbitrators, notwithstanding otherwise applicable federal law,” but noted that the provision also could be read merely to specify “what law to apply to disputes arising out of the contractual relationship.” Because the choice-of-law provision was not “an unequivocal exclusion of punitive damages claims” from the scope of the arbitration clause, the Supreme Court concluded that it would not read the provision as narrowing the scope of arbitrable issues to those arbitrable under New York law. The Court said that the choice-of-law clause merely “introduce[d] an ambiguity into an arbitration agreement,” and “federal policy favoring arbitration” dictated that the ambiguity in the scope of the arbitration clause be resolved in favor of arbitration.

Numerous later decisions have interpreted Mastrobuono as rejecting the notion that a general state choice-of-law clause contained in a contract that also includes an arbitration provision displaces the FAA in a federal case. These courts have emphasized that an arbitration

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17 Id. 514 U.S. at 59 n. 2 (emphasis added).
18 See id. 514 U.S. at 52.
19 See id. 514 U.S. at 53.
20 Id. 514 U.S. at 54-55.
21 Id. 514 U.S. at 60.
22 Id. 514 U.S. at 59-60.
23 Id. 514 U.S. at 53 and 62.
24 Id. 514 U.S. at 62.
25 See UHC Mgmt. Co., Inc. v. Computer Scis. Corp., 148 F.3d 992, 996 (8th Cir. 1998); Wolsey, Ltd. v. Foodmaker, Inc., 144 F.3d 1205, 1212-13 (9th Cir. 1998) (holding that because Mastrobuono dictates that general choice-of-law clauses do not incorporate state rules that govern the allocation of authority between courts and arbitrators, district court erred in applying California state law to deny petitioner’s motion to compel arbitration); Ferro Corp. v. Garrison Indus., Inc., 142 F.3d 926, 936-38 (6th Cir. 1998); Gallus Invs., L.P. v. Pudgie’s Famous Chicken, Ltd., 134 F.3d 231, 233 (4th Cir. 1998); Doctor’s Assoc., Inc. v. Distajo, 107 F.3d 126, 130-31 (2d Cir. 1997), cert. denied, 522 U.S. 948, 118 S.Ct. 365, 139 L.Ed.2d 284 (1997) (federal courts are not required to apply state law “unless it is clear that the parties intended state arbitration law to apply on a particular issue”); Nat’l Union Fire Ins. Co. of Pittsburgh, PA., 88 F.3d at 134-35; Paine Webber Inc. v. Elahi, 87 F.3d 589, 594 (1st Cir. 1996); Atl. Aviation, Inc. v. EBM Group, Inc., 11 F.3d 1276, 1280 (5th Cir. 1994).
agreement should not be construed as precluding application of the FAA unless it is abundantly clear that the parties intended that result.\textsuperscript{26}

C. Under the FAA, What Is a Court Supposed to Decide Regarding the Scope of an Arbitration Agreement?

Under the FAA, a court is supposed to decide whether a valid agreement to arbitrate exists and, if so, whether it covers the asserted claims.\textsuperscript{27} Because arbitration is a matter of contract, there is no obligation to arbitrate where the parties have not entered into a valid agreement to do so. Accordingly, if a party alleges that an agreement to arbitrate was procured by fraud or asserts another ground that exists at law or in equity “for the revocation of any contract,” the court will generally decide whether the alleged fraud or other ground for revocation invalidates the commitment to arbitrate.\textsuperscript{28}

The United States Supreme Court made it clear in \textit{Prima Paint Corp. v. Flood & Conklin Mfg. Co.},\textsuperscript{29} however, that while challenges to whether there is a valid arbitration agreement are gateway issues for the court, challenges to the contract containing the arbitration clause are for the arbitrator to decide. This principle is sometimes referred to as the severability doctrine. It requires the court to assume that the underlying agreement is valid while focusing only on the enforceability of the arbitration clause. In \textit{Prima Paint}, the party attacking the arbitration provision claimed that he was fraudulently induced to enter into the underlying agreement. The Supreme Court held that this was an issue for the arbitrator, not the court.\textsuperscript{30}

In \textit{Buckeye Check Cashing, Inc. v. Cardegna},\textsuperscript{31} the United States Supreme Court reversed the Florida Supreme Court and held that an attack on the underlying agreement containing an arbitration provision – as opposed to an attack on the arbitration provision itself – alleging that the contract was void \textit{ab initio} was an issue for the arbitrator, not the court, to resolve. The Court soundly rejected the plaintiff’s argument that a distinction should be made between a case, like \textit{Prima Paint}, where a party alleges that a contract is voidable, and a claim that a contract is void \textit{ab initio}.\textsuperscript{32}

\textsuperscript{26} See, e.g., Doctor’s Assoc., Inc. v. Distajo, 107 F.3d at 131; Union Fire Ins. Co. of Pittsburgh, PA., 88 F.3d at 134-35.

\textsuperscript{27} Moses H. Cone Mem’l Hosp., 460 U.S. at 24-25.


\textsuperscript{30} \textit{Id.}

\textsuperscript{31} \textit{Buckeye Check Cashing, Inc. v. Cardegna}, 126 S. Ct. 1204, 163 L.Ed.2d 1038 (2006).

\textsuperscript{32} See also \textit{DH Enters., Inc., v. Advanced Triple M Auto., Inc.}, 2004 WL 1535614 (Ky. Ct. App. 2004) (fraud claims not going specifically to the validity of an arbitration clause itself must be arbitrated).
In attempting to argue arbitration clause invalidity, claimants also cannot rely upon statutes or other laws that single out arbitration clauses for special treatment. Under the FAA, states cannot impose on arbitration clauses requirements that are not applicable to contract provisions generally.

Some courts have held that the parties may by contract delegate the issue of arbitration clause validity to the arbitrator. Even absent that delegation, the existence of a severability clause has prompted some courts to conclude that an attack on part of an arbitration agreement should be decided by the arbitrator. There are even some cases holding that the validity and effect of a class action waiver is an issue for the arbitrator in the aftermath of Green Tree Fin. Corp. v. Bazzle. But, more recently, a federal district court held that the validity of a class action waiver is for the court and not the arbitrator to decide. The court in that case invalidated the November 12, 2004 policy adopted by private dispute resolution forum JAMS in which JAMS concluded that class action waivers are invalid and will not be enforced, thus permitting class-wide arbitration. (JAMS later retracted this policy.)

Under the FAA, after a court determines that a valid agreement to arbitrate exists, its focus shifts to whether the particular dispute is subject to arbitration. This determination – whether a particular dispute falls within the scope of the agreement to arbitrate – is referred to as “arbitrability.” Where the dispute is a breach of contract claim arising out of the agreement, arbitrability is quite straightforward and rarely in doubt. Disputes often arise, however, where the allegations involve breach of statutory duties or abrogation of statutory rights, as well as business torts. While courts usually consider arbitrability in interpreting the scope of the parties’ agreement, disputes also can arise where the parties have “clearly and unmistakably” agreed that arbitrability will be determined in arbitration.

33 Cardegna was a class action, but apparently the plaintiff never challenged the validity of the class action waiver and that issue was not before the U.S. Supreme Court. Thus, the Supreme Court still needs to resolve the much more important issue of whether class action waivers are enforceable under the FAA even when they are invalid under state law. Courts around the country are divided on that issue and various state supreme courts presently have that issue before them. While the Cardegna opinion does not deal directly with that issue, it does reiterate the theme running through many of the Supreme Court’s arbitration opinions to the effect that state anti-arbitration policy must yield to the policy of the FAA to enforce arbitration agreements as written. See, e.g., Casarotto, 517 U.S. 681, 116 S.Ct. 1652 134 L.Ed.2d 902 (holding that the FAA preempted a Montana statute which limited the validity of arbitration agreements by conditioning their enforceability on compliance with several notice requirements); Allied-Bruce Terminex Cos., Inc. v. Dobson, 513 U.S. 265, 115 S.Ct. 834, 130 L.Ed.2d 753 (1995) (Alabama statute entirely prohibiting pre-dispute arbitration agreement preempted by FAA); Volt Information Sciences, Inc., 489 U.S. 468, 109 S.Ct. 1248; Southland Corp. v. Keating, 465 U.S. 1, 104 S. Ct. 852, 79 L.Ed.2d 1 (1984); Perry v. Thomas, 482 U.S. 483, 107 S.Ct. 2520, 96 L.Ed.2d 426 (1987).

34 See, e.g., Casarotto, 517 U.S. 68, 116 S.Ct. 1652, 134 L.Ed.2d 902.


37 See First Options of Chicago, Inc. v. Kaplan, 514 U.S. 938, 115 S.Ct. 1920, 1923, 131 L.Ed.2d 985 (1995) (consistent with the general notion of freedom of contract, parties can agree ahead of time to allow the arbitrator to resolve arbitrability disputes, but in the absence of “clear and unmistakable evidence” that the parties desire the arbitrator to decide arbitrability, the issue is for the court).
In deciding arbitrability, a court must resolve all doubts concerning the scope of coverage of an arbitration clause subject to the FAA in favor of arbitration. Therefore, a court simply cannot deny arbitration unless "it may be said with positive assurance that the arbitration clause is not susceptible of an interpretation that covers the asserted dispute."

D. Under the FAA, What Is a Court Not Supposed to Decide?

Once a court determines that a dispute is arbitrable, all other issues are to be decided at arbitration. In other words, if an “arbitrability” issue arises, it is presumptively for the court to decide; but issues other than “arbitrability” are presumptively arbitrable, that is, for the arbitrator to decide. Accordingly, courts typically reject arguments regarding the waiver of state statutory remedies because they do not raise “arbitrability” issues for the court to decide under the FAA.

Pursuant to Section 2 of the FAA, complaints about the waiver of statutory remedies are not grounds that exist at law or in equity “for the revocation of any contract.” Rather, they are separate and apart from the issue of whether a party has agreed to arbitrate, and hence are for the arbitrator to decide.

In franchise cases, this doctrine means that franchisee claims of franchisor statutory noncompliance (whether related to state franchise ‘registration/disclosure’ or ‘relationship’ statutes) – including claims that a franchisor illegally sought or obtained franchisee waivers of those laws’ protections – will not enable the franchisee to avoid arbitration and instead pursue judicial relief. Instead, such claims are to be heard and determined by the arbitration panel.


41 Paine Webber Inc. v. Hartmann, 921 F.2d 507, 511 (3rd Cir. 1990) quoting AT&T Technologies, Inc. v. Communications Workers of America, 475 U.S. 643, at, 106 S.Ct. at 1419, 89 L.Ed.2d 648; accord Wick v. Atlantic Marine, 605 F.2d 166, 168 (5th Cir. 1979); Genesco, Inc. v. T. Kakiuchi & Co., Ltd., 815 F.2d 840, 846 (2d Cir. 1987) (as long as “allegations underlying the claims ‘touch matters’ covered by the parties’ . . . agreements, if a party to the contract demands arbitration, then the claims must be arbitrated”) (citation omitted).

42 Great Western Mortgage Corp. v. Peacock, 110 F.3d 222 (3d Cir. 1997).

43 Id. at 230.

44 Id. at 231-33 (emphasis added). See also Harrison v. Nissan Motor Corp., 111 F.3d 343 (3d Cir. 1997); and Paine Webber Inc. v. Elahi, 87 F.3d 589.

45 Great Western Mortgage, 110 F.3d at 231-33.

46 See id. at 231-33 quoting 9 U.S.C. § 2.
III. MOTIONS TO COMPEL ARBITRATION

Arbitration is supposed to be a speedy and inexpensive alternative to litigation. Arbitration is neither quick nor inexpensive when one party resists arbitration and litigates to the hilt. While a party is entitled to seek a judicial resolution of its obligation to arbitrate, a party is not entitled to file claims or make arguments that ignore overwhelming contrary authority under the FAA and, therefore, have no effect other than to saddle its opponent with extra costs and burdens.47

Nevertheless, franchisees frequently sue despite their prior agreement to arbitrate all claims. A franchisee may prefer to have both the substantive claim(s) and the enforceability of the arbitration agreement decided in its home state court, which is frequently perceived as a more favorable venue than arbitration or federal court. While the franchisor can sometimes remove state court cases to federal court if there exists a federal question or diversity jurisdiction and seek a stay pursuant to Section 3 of the FAA, in many cases this will not be possible. Even if grounds exist for removal, removed cases are subject to remand challenges, and remand orders are not generally appealable. At the same time, attempting to obtain a stay from a state trial court pursuant to Section 3 of the FAA can lead to unpredictable and, too often, wrong legal results. Whether driven by judicial sympathy for local interests or the failure to apply applicable law properly, these results can cause severe prejudice to a franchisor's position, including otherwise avoidable delay and costs.

Section 4 of the FAA is the frequent answer to state court actions by franchisees who have agreed to arbitrate. Section 4 gives a franchisor the right to file a separate action in federal court, seeking to compel arbitration of the franchisee’s claims. Under Section 4:

A party aggrieved by the alleged failure, neglect, or refusal of another to arbitrate under a written agreement for arbitration may petition ... for an order directing that such arbitration proceed in the manner provided for in such agreement .... The court shall hear the parties, and upon being satisfied that the making of the agreement for arbitration or the failure to comply therewith is not in issue, the court shall make an order directing the parties to proceed to arbitration in accordance with the terms of the agreement.

(emphasis added).

However, the FAA does not itself confer subject matter jurisdiction on a federal court. Rather, there must be diversity or federal question jurisdiction over the underlying claim. If the substantive controversy exceeds $75,000 but the franchisee has named a non-diverse party in the state court as a co-defendant, the principal defendant can nevertheless initiate a Section 4 petition in federal court against the franchisee if the franchisor and the franchisee are of diverse citizenship.

The FAA by its express terms requires the rigorous enforcement of arbitration agreements.48 Indeed, overwhelming federal authority now exists to compel arbitration under...

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47 See Paine Webber Inc. v. Farnam, 843 F.2d 1050, 1052 (7th Cir. 1988) (cautioning that litigants must think twice before filing papers that put their adversaries to expense and think three times before filing such papers in cases involving arbitration).

48 Dean Witter Reynolds, Inc., 470 U.S. at 221, 105 S.Ct. at 1242-1243, 84 L.Ed.2d 158; accord Shearson/American Express, Inc. v. McMahon, 482 U.S. 220, 226 (1987); Mitsubishi Motors Corp. v. Soler Chrysler-Plymouth, Inc., 723 F.2d 155 (1st Cir. 1983), aff'd in pertinent part and rev'd on other grounds, 473
the FAA. Presented with that precedent, a federal district court typically does not ponder long whether litigants should be directed to proceed to arbitration once it has found an enforceable agreement to arbitrate and an arbitrable dispute.

IV. MOTIONS TO AVOID ARBITRATION

The cases under the FAA set forth a general policy favoring arbitration and, as discussed above, courts have taken a liberal view of what is arbitrable. Notwithstanding this view, overcoming a requirement to arbitrate is not impossible. In fact, litigation is beginning to regain favor among the courts.

A party seeking to avoid the application of an arbitration provision has several procedural avenues available. First, the party can simply ignore the arbitration clause and sue. Second, when served with a demand for arbitration, a party may move to enjoin the arbitration. Either way, the most common argument used to avoid arbitration is to allege that the franchise agreement as a whole is void and therefore the arbitration provision in the agreement is not enforceable. This argument typically arises in franchise disputes when a franchisee alleges that either the franchise agreement was induced by fraud, is illegal because of the franchisor’s violation of a state franchise law, or both. This argument has been almost universally unsuccessful. Courts throughout the country hold that when a party asserts that a contract containing an arbitration provision is not valid or enforceable, that question is to be determined in arbitration.

Rubin v. Sona Int’l Corp. applied Prima Paint and Cardegna in a franchise case. There the franchisee-plaintiff asserted that it was fraudulently induced to enter into the franchise agreement and that the franchisor violated the New York Franchise Sales Act (“NYFSA”) by failing to register its offering circular. When the franchisor moved to dismiss in favor of

U.S. 614, 626 (1985). See also Sharif v. Wellness Int’l Network, Ltd., 376 F.3d 720, 726 (7th Cir. 2004) (in reversing the district court’s denial of the defendant’s motion to compel arbitration based on a finding of waiver through participation in the litigation, the court explained that if parties have an arbitration provision and the asserted claims are within its scope, a motion to compel arbitration under the FAA cannot be denied).


See, i.e., Mastrobuono v. Shearson Lehman Hutton, Inc., 514 U.S. 52, 115 S.Ct. 1212, 1217-19, 131 L.Ed.2d 76 (1995); Southland Corp. v. Keating, 465 U.S. 1, 104 S.Ct. 852, 856, 79 L.Ed.2d 1 (1984) (“[c]ontracts to arbitrate are not to be avoided by allowing one party to ignore the contract and resort to the courts.”); Moses H. Cone Memorial Hospital v. Mercury Construction Corp., 460 U.S. 1, 103 S.Ct. 927, 941, 74 L.Ed.2d 765 (1983); Olde Disc. Corp. v. Tupman, 1 F.3d 202, 213 (3d Cir. 1993) (a litigant has a federal substantive right to enforcement of the arbitration agreements as written and a federal entitlement to a proceeding and a forum that are, at least ideally, speedy, efficient and simpler than litigation in the courts).

But see Cohen v. Stratis Bus. Ctrs., Inc., 2005 WL 3008807 *3 (D.N.J. 2005) (granting motion to compel, but concluding that franchisees should not be bound to contractual choice of forum and case should be arbitrated in New Jersey); Toy De Baja Cal., Inc. v. Toy Tire & Rubber Co., Bus. Franchise Guide (CCH) ¶ 13,117 (Cal.Ct.App. 2005) (trial court’s denial of a motion to compel arbitration was upheld).

R. Barkoff, N. Simon, W.M. Garner, and J Mazero, Twenty-Five Years of Franchising: Where have we Been Where Are we Going?, 25th Annual Forum on Franchising (2002), Plenary 1 and Lunch Programs, Tab P1, 38 (stating that it “appears that the pendulum may be swinging back away from arbitration.”)

Barker v. Golf U.S.A., Inc., 154 F.3d 788 (8th Cir. 1998) (holding that an assertion that a franchise agreement containing an arbitration was fraudulently induced is a matter for an arbitrator to decide).

arbitration. The franchisee argued that because the franchisor violated the NYFSA, the franchise agreement was void ab initio and the arbitration clause could not be enforced. Relying on Cardegna, the district court held that a challenge to the validity of the contract as a whole, and not specifically to the arbitration clause, must go to the arbitrator.

The franchisee-plaintiff in Chong v. Friedman 54 alleged that he was entitled to rescission because the franchisor misrepresented the franchise opportunity and failed to comply with California Franchise Investment Law (“CFIL”). The franchisor moved to compel arbitration. The trial court denied the motion but the appellate court reversed, holding that the franchisor’s alleged failure to comply with CFIL made the agreement voidable, not void. The appellate court further held, in line with Prima Paint, and the later decisions in Cardegna and Rubin, that the “issue of the illegality of the contract is subject to arbitration. An arbitration clause is enforceable in a contract that is voidable not void.” 55

In DH Enters., Inc. v. Advanced Triple M. Auto., Inc. 56 the franchisee-plaintiff sued to rescind a muffler shop franchise agreement because the agreement was fraudulently induced. The franchisor moved to dismiss and compel arbitration. The lower court denied the motion and the appellate court affirmed. Upon remand from the Kentucky Supreme Court, the Kentucky Court of Appeals later compelled arbitration because the “‘separability doctrine’ as it has become known, requires courts applying federal law to separate an otherwise valid arbitration clause from the contract which it is contained to allow arbitration of all claims not going to the validity of the arbitration clause itself.” 57

Until recently, franchisees in Illinois had been able to assert that a failure to comply with the Illinois Franchise Disclosure Act (“IFDA”) resulted in a failure to meet a condition precedent to formation of a contract. Therefore, since a contract never existed, went the argument, neither did the arbitration provision within that franchise agreement. In Barter Exch. of Chicago v. Barter Exch., Inc. 58 a franchisee sued to rescind a franchise agreement claiming that the contract was void and unenforceable because the franchisor’s registration with the state had lapsed on the date the franchise agreement was signed. The franchisor moved to compel arbitration. The trial court granted the motion because “the contract is voidable, not void...” The appellate court reversed, holding that the IFDA was a part of the contract and therefore compliance with the IFDA was a condition precedent to the enforceability of a franchise agreement. The court reasoned that “[t]he issue of whether the parties have entered into an enforceable contract is not arbitrable because the question of whether a contract existed is an issue of law determinable only by a court.” 59

55 Id. See also Nolan v. Hair Color Xpress Int’l, LLC, Bus. Franchise Guide (CCH) ¶ 13,049 (D.Minn. 2005) (where the franchisee argued that a Minnesota addendum to the franchise agreement rendered void certain portions of the arbitration clause and created an ambiguity regarding whether arbitration was in fact the exclusive means for resolving disputes, the federal court compelled out-of-state arbitration of plaintiffs’ fraud, estoppel, unjust enrichment, breach of contract, breach of fiduciary duty, and deceptive trade practice act claims).
57 Id. at *3.
59 DH Enters., Inc., 2004 WL 1535614 at *3.
However, in *Jensen v. Quik Int'l*, the Illinois Supreme Court withheld from franchisees the ability to avoid arbitration of a dispute because a franchisor failed to comply with the IFDA. In *Jensen*, a franchisee sued to rescind its franchise agreement because the franchisor was not registered under the IFDA. The franchisor moved to compel arbitration. In response, the franchisee relied upon *Barter Exchange* and argued that because the franchisor was not registered, a condition precedent to the formation of a contract was not met and the franchise agreement was unenforceable. The appellate court agreed and denied the franchisor’s motion, but the Illinois Supreme Court reversed, explicitly rejecting the *Barter Exchange* holding.

The argument that a violation of a state franchise law voids the whole franchise agreement, including its arbitration provision does not fail all the time. In *Nature’s 10 Jewelers v. Gunderson*, the South Dakota Supreme Court held that whether a franchise agreement containing an arbitration provision is void for illegality is a matter for a court. The franchisee alleged, among other causes of action, misrepresentation in the sale of a franchise and violation of South Dakota franchise statutes. The franchisor moved to compel arbitration and the trial court granted the motion, but the South Dakota Supreme Court reversed, holding that an unlawful contract is void, not voidable. The court relied on the fact that the franchisee signed the franchise agreement after the franchisor’s registration with the state of South Dakota expired. Further, the court held that it would not let a party benefit from its illegal act.

In reaching its decision., the South Dakota Supreme Court relied upon a Florida case, *Party Yards, Inc. v. Templeton*, in which a consumer alleged that it could void an illegal contract and avoid arbitration. However, it is likely that the Supreme Court’s decision in *Cardegena*, which addressed the same issue and overturned a decision of the Florida Supreme Court, makes *Nature’s 10* bad law.

V. LEGAL ATTACKS ON THE ENFORCEABILITY OF THE CLAUSE ITSELF

Generally applicable contract defenses, such as fraud, duress, or unconscionability, may be applied to invalidate arbitration agreements without contravening § 2 of the FAA. In addition, under some circumstances, franchisees can argue that a franchisor waived its rights to arbitrate. These arguments, discussed in more detail below, have had various levels of success and provide roadmaps for both future litigation about dispute resolution and drafting for counsel.

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62 *Id.* See also *Collorall Techs. Int'l, Inc. v. Plait*, Bus. Franchise Guide (CCH) ¶ 13,149 (S.D.Fla. 2005) (where franchisee argued that the FAA preempted California state law only if a valid agreement to arbitrate existed, and the parties had not truly agreed on an arbitration provision due to the franchisor’s alleged fraudulent misrepresentations (i.e., the UFOC’s representation that the arbitration clause might not be enforceable under California law), which prevented a “meeting of the minds” on the arbitration clause itself, court found that the franchisee had properly alleged an ambiguity regarding the applicability and scope of the arbitration clause and that the federal court in California to which the original lawsuit had been removed was the proper court to solve the franchisee’s fraudulent inducement claim under the “first-filed” doctrine); *Alphagraphics Franchising, Inc. v. Whaler Graphics, Inc.*, 840 F.Supp. 708, 710 (D.Ariz. 1993) (forum selection clause applicable to arbitration provision not enforceable against Michigan franchisees where offering circular stated that Michigan law prohibited out-of-state arbitration and franchisor failed to disclose that it intended to rely on FAA preemption to insist on enforcement of forum selection clause).


64 *Doctor’s Assoc., Inc. v. Jabush*, 89 F.3d 109 (2d Cir. 1996).
A. Fraudulent Inducement of Agreement to Arbitrate

In *Rubin v. Sona Int’l Corp.*, the franchisee claimed that the dispute resolution provision, as well as the franchise agreement itself, was induced by fraud, based on drafting discrepancies between the UFOC and franchise agreement. In rejecting this argument, the U.S. District Court for the Southern District of New York discussed factors that a party must establish successfully to challenge an arbitration provision. The court stated that “there must be a substantial relationship between the fraud or misrepresentation and the arbitration clause in particular….it must include particularized facts specific to the …arbitration clause which indicate how it was used to effect the scheme to defraud.” Additionally, the franchisee must establish that the franchisor misrepresented a material fact about the arbitration provision and that the franchisee relied on that misrepresentation. Although the court rejected the plaintiff’s argument, the case provides a framework for a potentially successful challenge to an arbitration clause.

In *Doctor’s Assoc., Inc. v. Jabush*, a sandwich shop franchisor brought six separate actions to compel arbitration against the defendants. The Connecticut federal district court consolidated the matters and compelled arbitration. The franchisee-defendants appealed. On appeal to the Second Circuit Court of Appeals, the franchisees argued that the agreement to arbitrate was induced by fraud and therefore a matter for the court. The Second Circuit vacated the order to compel arbitration and remanded, instructing the district court to rule on the issue of the asserted fraudulent inducement of the agreement to arbitrate.

B. One Sided Arbitration Clauses - Lack of Mutuality and Evasion Contracts

1. Lack of Mutuality

When faced with an arbitration provision that provides judicial remedies to a franchisor that are not available to a franchisee, a franchisee may argue that the arbitration provision is unenforceable because it lacks mutuality, which one court has defined as “symmetrical obligations to arbitrate.” Despite the FAA’s policy favoring arbitration, a few courts have begun to accept this argument as a basis for invalidating an arbitration provision. The key to a successful mutuality defense to arbitration may be which state law governs.

One hotel franchisee argued successfully that the arbitration clause in his franchise agreement lacked mutuality and was therefore unenforceable. In *Ticknor v. Choice Hotels Int’l, Inc.* a hotel franchisor filed a demand for arbitration. The franchisee moved in state court seeking a temporary restraining order staying the arbitration. The state court granted the application. The franchisor removed the case and moved to compel arbitration. The Ninth Circuit held that the arbitration provision lacked mutuality of obligation, was one-sided and contained unreasonable terms favoring the drafter. After determining that the FAA does not

66 Id. at *3.
69 *Ticknor v. Choice Hotels Int’l, Inc.*, 265 F.3d 931 (9th Cir. 2001).
preempt a state law contract defense to an arbitration provision, the Ninth Circuit performed a choice of law analysis. The Ninth Circuit determined that Montana law applied and held that under Montana law “an arbitration clause that ‘lacks mutuality of obligation, is one-sided, and contains terms that are favorable to the drafter’” is unenforceable.  

The Second Circuit rejected the franchisees’ mutuality argument in Doctor’s Associates, Inc. v. Distajo.  Distajo involved seventeen (17) separate actions consolidated for the purpose of resolving the franchisor’s petition to compel arbitration of the disputes. The franchisees asserted that the arbitration provisions in each of the franchise agreements lacked mutuality. The Second Circuit held that under Connecticut law, (the applicable law under the franchise agreement) “where the agreement to arbitrate is integrated into a larger unitary contract, the consideration for the contract as a whole covers the arbitration clause as well.” As the franchisees had not contested consideration for each of the franchise agreements as a whole, the agreements could not be invalidated.

One of the Connecticut federal court cases consolidated in Distajo involved a franchisee who had previously sued in Illinois state court and successfully argued that the franchise agreement arbitration clause failed for lack of mutuality. The analysis by the Illinois state court, in Shino v. Doctor’s Associates, Inc., is instructive. Applying Illinois law (which the federal courts later found inapplicable) the state court found that the arbitration provision in the franchise agreement was unenforceable for lack of mutuality because the franchisor’s leasing affiliates (which had commenced eviction proceedings in court) were not bound to arbitrate disputes with the franchisees. The court treated the affiliates as alter egos of the franchisor and stated that “the arbitration clauses in the franchise agreements lack mutuality because, while binding on the franchisees, they are not binding on Doctor’s Associates, Inc., which can employ its totally controlled and dominated subleasing companies … to resolve disputes arising under the franchise agreement.” The logic of the holding may be applicable in other jurisdictions (depending upon local law) in disputes where the franchisor reserves for itself or its affiliates the right to proceed in court, while the franchisee has no such right.

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71 Doctor’s Associates, Inc. v. Distajo, 66 F.3d 438 (2d Cir. 1995).

72 Distajo, 66 F.3d at 453 (internal quotations omitted).


74 In Distajo, the district court enjoined the franchisees from proceeding with their state court cases. Additionally, although the Illinois court previously ruled on the mutuality issue, the federal district court held and the Second Circuit affirmed that the Illinois court ruling was not entitled to a preclusive effect under the full faith and credit clause because the Shino ruling was appealable at the time the federal court was entertaining the issue and therefore not final under Illinois law. See Distajo, 66 F.3d at 449-50.

75 Id.

76 Although the Second Circuit in Distajo called mutuality “largely a dead letter,” the argument has since been used successfully to invalidate agreements to arbitrate. For example, the court applied the doctrine to invalidate agreements to arbitrate in Ticknor. In a consumer loan case, Showmethemoney v. Williams, the Arkansas Supreme Court, denied the defendants’ motion to compel arbitration because the agreement to arbitrate lacked mutuality. 342 Ark. 112, 27 S.W.3d 361 (Ark. 2000). Commentators have observed that the defense that a dispute resolution provision lacks mutuality is making a comeback. See Kaufman and Babbit, at p. 101, supra note 69 (“Recently, the archaic and moribund doctrine of ‘mutuality’ has been used to challenge and frequently defeat arbitration clauses in a number of states.”)
In a case that adds a unique twist to the mutuality argument, the Fourth Circuit applied Maryland law to a collection action by a Maryland based hotel franchisor and then compelled arbitration under the theory that allowing the action to proceed in court would remove mutuality from the parties' agreement to arbitrate. In *Choice Hotels Int'l, Inc. v. BSR Tropicana Resort, Inc.*, a hotel franchisor commenced litigation alleging breach of contract causing $586,000 in damages. The franchisee moved to compel arbitration, but the district court denied the motion. The agreement to arbitrate contained several exceptions which allowed the franchisor to commence an action in court, without providing similar rights to the franchisee, including "actions for collection of moneys owed." In opposing the motion to compel, the franchisor argued that the matter was not arbitrable because it was an action "for collection of moneys owed." The Fourth Circuit disagreed and held that the franchisor's broad interpretation of that clause "effectively transforms the arbitration provision into a unilateral commitment by [the franchisee] to arbitrate its claims while claims by [the franchisor] are subject to judicial determination." Therefore, the Fourth Circuit reversed and compelled the franchisor to arbitrate.

It is important to note that many courts do not find a lack of mutuality solely because the franchisor may seek redress from a court. In *Jacob v. C & M Video*, a franchisee sued in state court alleging common law fraud, violation of the IFDA disclosure provisions, and breach of contract. The franchisor moved to dismiss, asserting that the parties had agreed to arbitrate. The trial court denied the motion to dismiss. On appeal, the franchisee argued that "a mutual agreement to arbitrate was effectively abrogated by provisions granting one party a unilateral right to a judicial forum in the event of a breach of a franchise agreement." The Illinois appellate court disagreed and held that reserving the right to bring a trademark action in court did not mean that the arbitration provision lacked mutuality. In addition, the court noted that both parties had the right to commence litigation for injunctive relief. Further, the appellate court observed that nothing in the agreement stopped a party from litigating in court if the other party did not invoke its arbitration rights.

Franchisees also have attempted to argue that an arbitration provision lacks mutuality because a franchisor retains the right to litigate claims for moneys owed. In *Barker v. Golf U.S.A., Inc.*, a franchisee sued its franchisor in Missouri state court. The franchisor removed the matter to federal court and moved to dismiss, based upon the arbitration provision in the franchise agreement. The franchisee opposed the motion by arguing that the arbitration provision was unenforceable because it lacked mutuality. The franchisee contended that the right of the franchisor to bring a claim in court for monies owed made the franchisor's promise to arbitrate illusory. The Eight Circuit did not reach the mutuality argument. Instead, the court held

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77 *Choice Hotels Int'l, Inc. v. BSR Tropicana Resort, Inc.*, 252 F.3d 707 (4th Cir. 2001).

78 *Id.* at 709.

79 *Id.* at 710.

80 *Id.*


82 *Id.*, 248 Ill.App.3d at 659, 618 N.E.2d at 1271.

that under Oklahoma law, the arbitration provision was enforceable because the contract as a whole did not lack consideration.

A court also upheld an arbitration clause where the franchisor was required to arbitrate at least some of its claims but was the only party permitted to go to court. In *Blue Bird Body Co. v. United Bus Corp.*, a distributor of buses asserted that a clause allowing a school bus manufacturer to seek redress in court for claims for the payment of money made the arbitration provision unenforceable because of lack of mutuality. The district court disagreed, holding that “the fact that United is more likely than Blue Bird to be required to submit its claims to arbitration is not enough to invalidate the arbitration provision for lack of mutuality. Rather, mutuality of obligation is satisfied if both parties are required ‘to arbitrate at least some specified class of claims.’”

2. Adhesion Contracts

In challenging the enforceability of arbitration clauses, franchisees have sometimes successfully argued that the agreement to arbitrate is an unenforceable contract of adhesion. Traditionally, this argument has been used to protect consumers from agreements provided under “take it or leave it” circumstances. Some commentators contend that in many circumstances a franchisee is unable to negotiate the arbitration provision, and that this argument should therefore have greater applicability to franchising.

At least in California, as a matter of law, a franchise agreement can be deemed a contract of adhesion. In *Bolter v. Superior Court*, the franchisees of a carpet cleaning system filed a class action in California state court alleging breach of contract and the obligation of good faith and fair dealing after the franchisor required renewing franchisees to sign agreements which were substantially more onerous than the extant agreements. One of the provisions to which the franchisees objected was the new arbitration clause. In response to the class action, the franchisor commenced individual arbitration proceedings in Utah. After the franchisees’ attorneys objected to the arbitrations, claiming that the disputes were not arbitrable, the arbitrators conducted telephonic hearings on the issue, which the franchisees did not attend, and determined that the matters were, in fact, arbitrable. The franchisor then moved to confirm the arbitrators’ awards regarding arbitrability, and the trial court confirmed the awards, granted a motion to compel the completion of the arbitrations and stayed the state court action.

On appeal, the court of appeals issued a writ of mandamus directing the trial court to vacate the arbitration awards and strike from the arbitration clauses in the renewal agreements provisions regarding forum selection, consolidation restrictions and damages limitations. The appellate court found that although there is “nothing inherently unfair or oppressive about arbitration clauses … it is not the requirement of arbitration alone which makes the provision unfair but rather the place or manner in which the arbitration is to occur.” The court found the


88 Id. at 894.
new arbitration requirements were adhesive because the “place” and “manner” provided for in the clauses “were oppressive” to the franchisees, who were usually “one man operated” businesses, and to participate in an arbitration in Utah they had to leave their businesses, incur travel expenses and retain local counsel. The court also noted that many of the franchisees were long time franchisees who were forced to accept these terms or face termination.

In Byerrum v. Re/Max of California and Hawaii, Inc., a real estate franchisee sued its franchisor in state court. The franchisor moved to compel arbitration. In opposition to the motion to compel, the franchisee argued that the offer for a renewal was on a take it or leave it basis. Although not calling the arbitration provision a contract of adhesion, the court declared the arbitration agreement in the franchise agreement unenforceable. In so holding, the court discussed the fact that since the franchisee had been in business with the franchisor for seventeen (17) years, changing affiliations would be detrimental to the franchisee’s business. The offer for a renewal with changes to the provision to arbitrate was therefore deemed to be on a take it or leave it basis.

Inexperienced franchisees also have been heard to argue that a franchise agreement is an adhesion contract. In Choice Hotels Int’l Inc. v. Chewl’s Hospitality, Inc., the United States Court of Appeals for the Fourth Circuit refused to vacate an arbitration award on the grounds that the franchise agreement arbitration clause was an adhesion contract. In so holding, the Fourth Circuit stated that under Maryland law, an adhesion contract is “drafted unilaterally by the dominant party and then presented on a take-it-or-leave-it basis to the weaker party who has no real opportunity to bargain about its terms.” The Fourth Circuit rejected the franchisee’s argument because the franchisee was an experienced hotel owner who negotiated the terms of the agreement. One interesting aspect of this decision is the Fourth Circuit’s inclusion of a roadmap under Maryland law for an attorney to make the adhesion argument on behalf of an inexperienced franchisee.

C. Unconscionability

One of the standard contract defenses that exist at law or in equity for the revocation of any contract is unconscionability. Because franchisees who can demonstrate the unconscionability of an arbitration provision to a trial court may be able to either avoid arbitrating or reform the arbitration provision, litigation over the alleged unconscionability of arbitration provisions has become a battleground.

89 Id. at 894.
93 See, e.g., Kent Klosterman v. Choice Hotels Int’l, Inc., 91 Fed.Appx. 810 (D. Idaho 2005) (holding that the court, not the arbitrator, should consider the issues of whether an arbitration clause was unconscionable, whether the franchisee had waived its unconscionability objection to the arbitration provision and whether the arbitration clause covered claims for liquidated damages). See also, Bethany L. Appelby, Carmen D. Caruso and Charles Griffith Towle, Unconscionability and Franchise Litigation, 29th Annual Forum on Franchising (2006), Lunch Programs, W2 (analyzing and considering various unconscionability arguments in franchise litigation).
The doctrine of unconscionability has both substantive and procedural elements, both of which relate to the making of an agreement and thus are issues for the court to decide. Substantive unconscionability takes a number of forms but generally is characterized by grossly one-sided terms. Procedural unconscionability relates to the issue of whether the contract provision is a part of a contract of adhesion.

Unconscionability defenses to enforcement of an arbitration clause have taken many forms. Franchisees have argued that an arbitration provision is unconscionable because it violates a state disclosure or relationship law statute, which either authorizes a franchisee to go to court in a particular jurisdiction, permits a class action or provides the franchisee with some other right, such as the right to exemplary damages or to receive counsel fees if it prevails. Franchisees also have been heard to argue that an arbitration provision is unconscionable because (1) the arbitration fees are too high; (2) the arbitration administrator is biased in favor of the franchisor ("repeat customer" or "frequent user" argument); (3) class action litigation is barred; (4) the franchisee was caught unaware of the terms or effect of the arbitration by an overreaching franchisor; (5) the arbitration clause has grossly unfair procedural limitations and/or is structurally biased; and (6) the arbitral forum is inconvenient. Franchisees who are relatively less sophisticated or experienced will often have stronger unconscionability claims than those who are experienced businesspersons.

1. The Arbitration Process Is Designed or Has the Practical Effect of Depriving the Franchisee of Substantive Rights or Claims Under Franchise Statutes that Reflect Fundamental Public Policy

The United States Supreme Court has held that when parties agree to arbitrate disputes, they do not relinquish substantive rights under statutes. In Mitsubishi Motors, the Supreme Court went so far as to note that "in the event the choice-of-forum and choice-of-law clauses operated in tandem as a prospective waiver of [the plaintiff’s] right to pursue statutory remedies for antitrust violations, we would have little hesitation in condemning the agreement as against public policy." Franchisee arguments that an arbitration clause is unenforceable because it represents an unconscionable limit on substantive rights have brought decidedly mixed results. In response to such arguments, some courts have held that the entire arbitration clause must be stricken from the agreement. For example, in Graham Oil Co. v. Arco Products Co., the defendant attempted to avoid the statutory protections afforded by the Petroleum Practices Marketing Act, 15 U.S.C. §§ 2801-2806 by including language in the arbitration provision that purportedly required the franchisee to forfeit rights under the Act. The Ninth Circuit severed and eliminated the entire arbitration clause after finding that the components of the arbitration clause improperly required the waiver of federal statutory rights. Several other courts recently have deemed entire arbitration clauses to be unconscionable and therefore unenforceable even

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95 Mitsubishi Motors, 473 U.S. at 637, 105 S.Ct. at 3359, 87 L.Ed.2d 444.

96 Graham Oil Co. v. Arco Products Co., 43 F.3d 1244 (9th Cir. 1995).

97 Id. at 1248-49.
where the franchisee’s claims were not federal and otherwise were susceptible to FAA pre-
emption and severability arguments. 98

Other courts have given the same argument absolutely no traction. 99 These courts
typically ground their reasoning in the FAA’s mandate to enforce arbitration agreements as
written once a controversy is found to be arbitrable, reserving all other issues for the
arbitrator. 100

2. Class Action Bars

In several recent cases, courts used the presence of class action waiver provisions as a
basis to declare arbitration agreements unconscionable and, in certain instances, chose to
reform the arbitration provision by striking the offending class action waiver rather than declaring
the entire arbitration provision unlawful.101

In Indep. Assoc. of Mailbox Ctr. Owners, Inc.,102 the California Court of Appeal upheld a
trial court’s motion to compel arbitration, but struck portions of the arbitration provisions as
unconscionable. The court held that the ban on class arbitration was unconscionable and
unenforceable under California law, including Section 1281.3 of the California Civil Code, which
permits a Superior Court to consolidate separate arbitration proceedings under certain
circumstances and vests the trial court with discretion to determine the rights and duties of the
various parties to achieve substantial justice. Accordingly, the appellate court held that the

restrictions on the arbitrator’s potential award of punitive damages, which are available under the California
franchise statute, made the entire arbitration clause unconscionable and unenforceable); Indep. Assoc. of
Mailbox Ctr. Owners, Inc. v. Superior Court, 34 Cal.Rptr.3d 659 (Ct.App. 2005) (discussed below). See also
Twin Cities Galleries, LLC, 415 F.Supp.2d at 967 (vacating arbitration award where California arbitration
panel held to have violated Minnesota’s public policy of protecting its franchisees by applying California
choice of law provisions and failing to apply Minnesota’s franchise protection statute). But see Chong v.
(reverseing the trial court’s finding that the parties’ dispute could not be arbitrated and remanding with
directions to strike the Nevada choice-of-law provision in the arbitration clause, which was found to be
invalid as against California’s public policy but severable from the remainder of the contract).

99 See Shaffer v. Graybill, 68 Fed.Appx. 374, 377 (3d Cir. 2003) (after noting that an adhesion contract is only
unenforceable when it is unconscionable or oppressive, unreasonably favoring one party over the other,
the court found no such unconscionability or oppression and reversed the district court’s denial of the
defendant’s motion to stay pending arbitration); Blimpie Int’l, Inc. v. Butterworth, 2005 WL 756218 (S.D.Ind.
2005) (where the franchisees argued that their Indiana Franchise Act claims were not arbitrable because they
were carved out from the franchise agreement’s jury waiver clause and the arbitration clause was, in effect, an
impermissible jury waiver, the court disagreed and compelled arbitration of all claims against the franchisor and its non-
signatory leasing subsidiary because the arbitration clause reached all claims tangentially related to the franchise
class arbitration agreement, including the franchisees’ fraud claim); Arora v. Jackson Hewitt Inc., Bus. Franchise Guide (CCH)
¶ 12,615 (C.D.Cal. 2003) (holding in an arbitration context that a Virginia choice of law provision in a tax
preparation service franchise agreement was enforceable and Virginia law concerning arbitration clauses
was not violative of California public policy). See also, Doctor’s Assoc. v. Hamilton’, 150 F.3d 157, 164 (2nd
Cir. 1998) (franchisee waived argument regarding unconscionability of choice-of-law analysis and provision
under New Jersey law by failing to raise issue to the trial court).

pending arbitration and deferring choice of law questions involving waiver of Connecticut franchise law
protections to arbitrator).

101 See Class Actions and Consolidations in Arbitration, infra Section VI

franchisees had made a showing for consolidated arbitration under Section 1281.3 and struck the provision in the JAMS arbitration provision barring class arbitration. In doing so, the court noted that franchise agreements have characteristics of contracts of adhesion because of the imbalance of power between franchisor and franchisee. The court then held that the trial court was in error when it ruled that (1) the arbitration provision was not unconscionable based on its findings that the franchisees had not attempted to negotiate it, and (2) there was no evidence that the provision was difficult to read or that the plaintiffs lacked sophistication. Several other courts also have held recently that the fact that an arbitration clause denies claimants access to class proceedings may contribute to a finding of unconscionability.103

3. The Arbitration Fees Are Too High

Because some arbitration organizations impose filing and hearing fees that exceed typical court fees, franchisees sometimes contend that the arbitration clause is unconscionable because it imposes an unreasonable financial burden and effectively denies them an affordable forum. See “Franchisee Perspective on Arbitration,” Section I.A. above. Typically, these arguments have failed.104 Nevertheless, the arbitration cost argument has resonated in various other settings, particularly consumer finance, and franchisees have continued to advance it as a potential basis for holding an arbitration clause unconscionable.105

4. The Arbitration Administrator Is Biased in Favor of the Franchisor (i.e., the “Frequent User” or “Repeat Customer” Argument)

Another frequently heard unconscionability argument is that the arbitration administrator is biased in favor of the franchisor, because of the franchisor’s alleged status as a frequent user or repeat customer. To date, franchisees also have not prevailed on this argument.106 However,

103 See, i.e., Discover Bank v. Superior Court of Los Angeles, No. S113725, 2005 WL 1500866 (Cal. 2005) (class action waiver in a consumer contract of adhesion is unconscionable if California law applies when the dispute involves small amounts of damages and is not preempted by the FAA; case remanded to determine whether Delaware choice-of-law clause should be enforced) (upon remand, the Court of Appeal, Second District, Division One, applied Delaware law and enforced the class action waiver. Discover Bank v. Superior Court, 36 Cal.Rptr.3d 456 (2005); Powertel, Inc. v. Bexley, 743 So.2d 570, 576-77 (Fla.Dist.Ct.App. 1999) (holding mandatory arbitration clause unconscionable in part because it would have denied phone customer right to proceed in class action).

104 See Doctor’s Assoc., Inc. v. Stuart, 85 F.3d 975, 980 (2nd Cir. 1996) (rejecting defendant’s argument that the arbitration clause was unconscionable because, inter alia, the clause did not disclose that the AAA charged as much as $5,000 for filing and administrative fees), Doctor’s Assoc. v. Hamilton, 150 F.3d 157 (2nd Cir. 1998) (following Stuart and rejecting claim that clause was invalid because franchisee would be required to pay one-half of AAA’s fees or approximately $28,000 - $32,000); Doctor’s Assoc., Inc. v. Jabush, 89 F.3d 109 (2d Cir. 1996) (court rejected franchisee’s argument that the arbitration clause was unconscionable because the clause did not disclose that the AAA charges for filing and administrative fees).

105 See, e.g., Cole v. Burns Int’l Sec. Servs., 105 F.3d 1465 (D.C.Cir. 1997) (holding that employee should not be required to pay fees); In re Knapp, 229 B.R. 821, 838 (Bankr.N.D. Ala. 1999) (refusing to enforce arbitration clause in part on finding of unconscionability where debtor would be required to pay for arbitration); Patterson v. ITT Consumer Fin. Corp., 18 Cal.Rptr.2d 563, 565-67 (Cal.Ct.App. 1993) (refusing to enforce arbitration clause imposed by financing organization on California consumers where clause apparently required arbitration to be heard in Minneapolis and required plaintiffs to pay substantial filing fees); and, Brower v. Gateway 2000, Inc., 676 N.Y.S.2d 569, 573-75 (App.Div. 1998) (striking portion of arbitration clause that designated a “financially prohibitive forum” to be unconscionable where expense was so great as “to deter individual consumer from invoking the process”).

106 See, i.e., Doctor’s Assoc., Inc. v. Hu, Bus. Franchise Guide (CCH) ¶ 12,656 (D.Conn. 2003) (in confirming an arbitration award, the court rejected the allegation that the arbitration award was tainted by a “conflict of interest” because the Connecticut American Arbitration Association office benefited from Subway’s inclusion of
courts have accepted unconscionability arguments with respect to clauses that mandate a potentially biased arbitrator.\textsuperscript{107}

5. The Franchisee Was Caught Unaware of the Terms or Effect of the Arbitration By an Overreaching Franchisor

Arbitration clauses that are part of a contract of adhesion are vulnerable to being deemed procedurally unconscionable. Typically, there are two judicially imposed limitations on the enforcement of contracts of adhesion: (1) if a contract or provision does not fall within the reasonable expectations of the weaker party, and (2) even if the contract is within the reasonable expectations of the parties, it will not be enforced if it is unduly oppressive or unconscionable.

The first limitation on contracts of adhesion, the reasonable expectations of the weaker party, is frequently expressed by a franchisee who alleges surprise at the effect of an arbitration clause. Absent extraordinary facts, an unconscionability argument predicated upon surprise is difficult to make in a franchise case because, among other things, franchisees receive UFOCs and an opportunity to review their proposed franchise contracts before execution.\textsuperscript{108}

6. The Arbitration Clause Has Grossly Unfair Procedural Limitations or Is Structurally Biased

The second limitation on contracts of adhesion discussed above, unduly oppressive or unconscionable terms, frequently revolves around an arbitration clause’s allegedly unfair procedural limitations or structural bias. Challenges to arbitration on this ground are extraordinarily fact intensive and, not surprisingly, have seen decidedly mixed results. Absent grossly unfair procedural limitations or structural bias that all but deprive a franchisee of any opportunity to present its claims, this argument typically fails.\textsuperscript{109} But several courts have refused to enforce arbitration agreements where the clause appeared to contain grossly unfair


\textsuperscript{108} See Nagrampa v. MailCoups Inc., 401 F.3d 1024, (9th Cir. 2005) (where the franchisee claimed that the arbitration clause was procedurally unconscionable because it was found on the twenty-fifth page of a thirty-five page contract, the court rejected the franchisee’s contention that the clause was unconscionable because the franchisee could not use her own lack of diligence to avoid an arbitration clause, and the franchisee should have read the agreement or consulted a lawyer about its ramifications); Mkt. Am., Inc. v. Tong, 2004 WL 1618574 (M.D.N.C. 2004) (where distributors contended that an arbitration clause was unconscionable in light of the small size of the print in the agreement that they signed, the court held that the smaller type size used in the arbitration clause of their agreement did not make the clause unconscionable and the distributors “had ample opportunity to make themselves aware of the terms of the arbitration provision” and their failure to do so was not as a result of any overreaching by franchisor). See also, Doctor’s Assoc. v. Hamilton, 150 F.3d 157 (clause providing for arbitration in Connecticut was not unconscionable because franchisee was on notice).

procedural limitations or structural bias. Accordingly, franchisors who choose to rely upon arbitration as a dispute resolution mechanism remain wise to include a visibly prominent and procedurally fair arbitration clause.

7. The Chosen Arbitral Forum Is Inconvenient

Another frequently asserted unconscionability argument is that the chosen arbitral forum is inconvenient. With some notable exceptions, courts have typically enforced provisions in arbitration clauses directing venue to a forum outside the franchisee’s home state.

D. Waiver

A party also may try to avoid arbitration by establishing that the other party to the agreement to arbitrate has waived its right to arbitrate. The success of this argument is limited because of the FAA’s policy favoring arbitration. Waiver of arbitration is not a favored finding and there is a presumption against it.

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110 See Vlahos v. Int’l Baking Co., 2005 WL 1632089 (Cal.Ct.App. 2005) (unpublished) (affirming a lower court decision holding that the court, not the arbitrator, decides whether an arbitration provision is unconscionable, and then holding that the arbitration provision at issue was both procedurally and substantively unconscionable because, among other things, an arbitration clause requiring mediation within ten days of the date on which facts concerning the dispute first came to the party’s attention, the commencement of an arbitration within twenty days of the termination of mediation, barring the recovery for punitive damages and expressly incorporating a “business judgment” rule was unconscionable). See also Hooters of Am. Inc. v. Phillips, 39 F.Supp.2d. 582 (D.S.C. 1998) (arbitration clause found to be unconscionable, contrary to public policy and illusory based on the fact that it (a) restricted employees’ rights as to compensatory and punitive damages, back pay and attorney’s fees; (b) sharply limited employees’ rights to appeal the arbitrator’s decision; (c) allowed Hooters to pick the master list of approved arbitrators; (d) limited discovery by allowing for only one deposition, and required employees - but not Hooters - to divulge the identity of their witnesses; and (e) allowed the arbitrator to sequester the employee’s witnesses, but not Hooters’ witnesses), aff’d Hooters of Am., Inc., 173 F.3d. 933 (based on promulgation of unfair rules in breach of implied covenant of good faith and fair dealing); Ditto v. REMAX Preferred Prop., 861 P.2d. 1000 (Okla.App. 1993) (arbitration denied when mechanism for selecting arbitrators was one-sided); Cheng-Canindin v. Renaissance Hotel Assocs., 57 Cal.Rptr.2d 867, 877-78 (Cal.Ct.App. 1997) (arbitration clause invalidated which provided for hotel management as arbitrators).

111 See, i.e., Bolter v. Superior Court, 104 Cal.Rptr.2d 888 (Cal.Ct.App. 2001) (where franchisees brought action against franchisor claiming that it breached franchise agreements and the court compelled arbitration in a foreign state, the Court of Appeal held that the franchise agreements’ prohibition against class-wide arbitration, limitation of damages and forum selection provisions were unconscionable, but unconscionability could be cured by striking the unduly oppressive provisions), as modified on denial for rehearing, 2001 DJDAR 3267 (Mar. 30, 2001) (upon a petition for rehearing, the Court limited its opinion so that only the distant forum provision was held to be unconscionable).

112 See Collorall Techs. Int’l, Inc. v. Plait, Bus. Franchise Guide (CCH) ¶ 13,149 (S.D. Fla. 2005) (the FAA preempts any California law prohibiting a franchisor from requiring its franchisees to arbitrate outside of California); Quizno’s Master, LLC v. Kadriu, 2005 WL 948825 (N.D.II. 2005) (where the franchisee argued that the arbitration clause was invalid under the reasoning of Green Tree Fin. Corp.-Alabama v. Randolph, 531 U.S. 79, 90-91, 121 S.Ct. 513, 521-23, 148 L.Ed. 2d 373 (2000), namely, arbitration would be too expensive, the court held that the franchisee could not rely on Green Tree because no federal statutory claims were at issue and she had not demonstrated that arbitration would be prohibitively expensive for her). See also Carnival Cruise Lines, Inc. v. Shute, 499 U.S. 585, 111 S.Ct. 1522, 113 L.Ed.2d 622 (1991) (upholding the validity of a forum selection clause); Scherk v. Alberto-Culver Co., 417 U.S. 506, 519, 94 S.Ct. 2449, 2458, 46 L.Ed.2d 270 (1974) (calling an arbitration provision “a specialized kind of forum selection clause”).
In general, waiver is found “when the party seeking arbitration substantially invokes the judicial process to the detriment of or prejudice to the other party.” In addition to addressing mutuality, as discussed above, Doctor’s Associates, Inc. v. Distajo is a case where waiver figured centrally. The franchisees argued that the franchisor had waived its right to arbitrate because its leasing company affiliates were able to sue the franchisees under their subleases. Before determining whether there had been waiver, the Second Circuit analyzed two questions: 1) who should determine the issue of waiver, the courts or the arbitrators and 2) the standard to be applied by the decision maker. As to who determines waiver, the Second Circuit concluded that generally in cases involving petitions to compel arbitration under § 4 of the FAA the defense of waiver is referable to the arbitrators. However, when an action is commenced in court and a party asserts waiver as an equitable defense to an application to stay the court proceeding under § 3 of the FAA, waiver is a matter for the courts.

After concluding that the issue of waiver in Distajo was for the court to determine, the Second Circuit instructed the district court to make factual determinations on three issues: 1) whether the leasing companies were alter egos of Doctor’s Associates and thus Doctor’s Associates was responsible for commencing the eviction proceedings; 2) whether prosecution of those eviction actions constituted litigation of “substantial issues going to the merits”; and 3) whether the franchisees were prejudiced by the eviction proceedings. On remand, the United States District Court for the District of Connecticut determined that the franchisees failed to establish the defense of waiver because the issues in the eviction were not arbitrable, and “[l]itigation involving claims that were not arbitrable does not constitute a waiver of the right to arbitration.” The franchisees appealed again.

The Second Circuit (in what became known as Distajo II) affirmed, holding that the eviction claim was distinct from claims relating to the franchise agreement. The Distajo II court analyzed the underlying claims in greater detail than the court in Distajo I, which did not consider the similarity of the claims between the eviction action and franchise disputes. The Distajo II court observed that “this factor [the similarity of the claims] is, of course, significant in considering whether DAI litigated ‘substantial issues going to the merits’ of the claims it now seeks to arbitrate.” Finding that the claims were distinct, the court affirmed the lower court’s order granting Doctor’s Associates, Inc.’s petitions to compel.

In line with Distajo, a New York state court found in Shergill v. TWR Express, Inc. that the franchisor waived its right to demand arbitration because it participated in a class action. During the course of the litigation, the franchisor had made substantive motions, sought discovery from plaintiffs, and failed to respond to discovery, which forced plaintiffs to issue

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116 Id. at 1020.


118 Id. at 132.

subpoenas to non-parties to obtain the materials sought. These measures delayed the action and increased plaintiffs’ costs. In holding that the franchisor waived its right to arbitrate the court defined the prejudice required to find waiver. “Prejudice results ‘when a party seeking to compel arbitration engages in discovery procedures not available in arbitration, makes motions going to the merits of an adversary’s claims, or delays invoking arbitration rights while the adversary incurs unnecessary delay or expense.’”

Rulings on the waiver defense to arbitration indicate that it is the degree of participation in litigation that will determine whether a party has waived its right to arbitrate. In Barber v. Gloria Jean’s Gourmet Coffee Franchising Corp., the court found that there was no such waiver. The court stated that three months of litigation, in which the franchisor propounded and responded to discovery, “did not constitute an invocation of the judicial process sufficient to effect a waiver of their right to arbitrate.”

VI. CLASS ACTIONS AND CONSOLIDATIONS IN ARBITRATION

Another hot topic in litigation over arbitration relates to class and consolidated arbitrations. Franchisors use arbitration provisions as a means for eliminating this type of collective franchisee action. Some arbitration clauses in franchise agreements contain explicit provisions prohibiting class or consolidated arbitrations; others are silent on the issue. In addition, when faced with a class action commenced in court, franchisors routinely rely on arbitration provisions as a way to force franchisees to arbitrate in individual proceedings. Class action limitations are extremely powerful and in fact one commentator called arbitration clauses “an effective tool for managing these … class action risks” and has termed these provisions a “class action shield.”

For years franchisors used arbitration provisions to avoid class litigation. In addition, courts held that class arbitration was unavailable under the FAA unless explicitly provided in the dispute resolution provision. The majority of federal courts that ruled on the issue determined that there could be no class or consolidated or group action without express agreement. It was held that silence in the provision shows that the parties did not contemplate resolving the dispute in a class or multiple party arbitration. In Doctor’s Assoc., Inc. v. Bennett, the court enjoined a class action based upon agreements to arbitrate in the franchise agreements. Also,

120 Id.
122 Id. at 3.
123 In a study of franchise agreements registered in Minnesota, Christopher Drahozal surveyed the terms of 75 franchise agreements. Mr. Drahozal found only one that provided for consolidated arbitration, 15 percent expressly prohibited consolidated arbitration, another 15 percent limited arbitration to claims involving the franchisee and the remainder were silent. In terms of class arbitrations, Mr. Drahozal found that 53 percent of the agreements expressly prohibited class arbitration. C. Drahozal, Arbitration Clauses in Franchise Agreements: Common (and Uncommon) Terms, 22 Franchise L.J. 81 (Fall 2002).
125 Id. citing for example Champ v. Siegel Trading Co., 55 F.3d 269 (1995).
126 Doctor’s Assoc., Inc. v. Bennett, Bus. Franchise Guide (CCH) ¶ 11,331 (2nd Cir. 1998).
in *Collins v. Int’l Dairy Queen*,\(^{127}\) the court denied the plaintiff-franchisee’s motion to compel notice of the class to additional franchisees.

Recently, in *Green Tree Fin. Corp. v. Bazzle*,\(^{128}\) the Supreme Court determined that when an arbitration provision is silent on the issue of class arbitration, an arbitrator decides whether a class arbitration is appropriate. This decision reopened the prospect for class arbitrations: shortly after the Supreme Court’s decision in *Green Tree*, the AAA promulgated supplementary rules for handling class arbitrations.

In *Green Tree*, a matter involving consumer loans, two separate groups of consumers, the Bazzle Group and the Lackey Group, sought class certification in South Carolina state court. Green Tree moved to compel arbitration pursuant to the arbitration provisions in the consumer loan agreements. In the Bazzle Group case, the trial court granted class certification and compelled arbitration. Administering the matter as a class arbitration, the arbitrator awarded damages to the consumers. After the trial court confirmed the award, Green Tree appealed.

In the Lackey Group case, the trial court denied Green Tree’s application for arbitration, finding the arbitration agreement unenforceable. Green Tree appealed and the South Carolina Supreme Court reversed. Later, the same arbitrator as in the Bazzle Group case certified the Lackey Group case as a class arbitration and awarded damages to the Lackey Group. The trial court confirmed the award and Green Tree appealed. The South Carolina Supreme Court consolidated the appeals and held that since the agreements were silent with respect to class arbitration, they authorized class arbitration and therefore the arbitrations were proper.

The U.S. Supreme Court granted certiorari to “consider whether the holding is consistent with the Federal Arbitration Act.” The Supreme Court vacated the South Carolina high court’s ruling based upon the broad language in the arbitration provision. In reaching its decision, the Supreme Court reasoned that the “relevant question here is what kind of arbitration proceeding the parties agreed to” and held that when an arbitration agreement is silent on class arbitration, whether to certify a class is a question for the arbitrator.

Some courts have permitted consolidated arbitrations involving franchisees who signed separate but similar agreements. In *Birmingham News v. Horn*,\(^{129}\) an arbitration panel ordered the consolidation of the cases of six franchisees with franchise agreements containing identical language. After an award in favor of the franchisees, the franchisor challenged the award arguing that the arbitrators exceeded their authority by ordering the consolidation. The Alabama Supreme Court disagreed, holding that “based on the state of the law, we cannot say that the arbitrators exceeded their powers in consolidating the cases for purposes of holding one hearing; in doing so they were exercising their discretion in structuring arbitration procedures.” In a similar case, *Zaks v. TES Franchising*,\(^{130}\) the District Court compelled a consolidated arbitration of two franchise disputes.

Finally, a recent case involving the Mailboxes, Etc. franchise system expanded the logic of *Bazzle* to situations where the parties expressly agreed to a ban on group litigation. In *Indep.*

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\(^{129}\) *Birmingham News v. Horn*, 901 So.2d 27 (Ala. 2004).

Assoc. of Mailbox Center Owners v. Superior Court, which was decided under California law, the franchise agreements in question contained express limitations banning group litigation. The Superior Court denied the franchisees’ request for consolidation based on these contract provisions and rejected the franchisees’ claims that the provisions were unconscionable. On a Writ of Mandamus, the California Court of Appeal ordered the trial court to vacate its denial of the franchisees’ motion and directed that the franchisees’ claims be consolidated. Although the case may be a California anomaly, it addresses issues relating to unconscionability and adhesion contracts that may have wider implications.

VII. COMPELLING NON-PARTIES TO ARBITRATE

In today’s complex world of franchising, contractual relationships are not limited to the franchise agreement between the franchisor and the franchisee. A franchisee may have to enter into various other agreements with the franchisor’s affiliates to operate the franchise in accordance with the franchise agreement. For example, a franchisee may be required to sign sublease or supply agreements. When disputes arise in these franchise-related relationships, where are they to be resolved?

Although many franchisees do not like arbitration, when the franchisee is required to arbitrate its dispute with a franchisor, the last thing it wants is a contemporaneous action in court with a franchisor’s affiliate. If the franchise agreement has an arbitration provision but the agreement with the affiliate does not, can the franchisee compel the affiliate to arbitrate? This section reviews the circumstances under which a non-signatory to a franchise agreement can be compelled to arbitrate. (Of course, as discussed above, where the agreement with the franchisor’s affiliates does not provide for arbitration, the franchisee may prefer to argue that the franchise agreement arbitration clause lacks mutuality, so that all disputes must go to court.)

As a general rule, “arbitration is a matter of contract and a party cannot be required to submit to arbitration any dispute which he has not agreed to so submit.” Nevertheless, when an agreement contains a broad arbitration provision, courts recognize a number of theories under which non-signatories can be compelled to arbitrate.

In Thomson-CSF, S.A. v. Am. Arbitration Assoc., which was not a franchise case, the plaintiff appealed a district court decision compelling it to arbitrate a dispute under a contract containing an arbitration provision signed by its subsidiary. The Second Circuit reversed, but set forth a framework under which non-signatories to an agreement providing for arbitration could be compelled to arbitrate. This framework, involving “ordinary principles of contract and agency law,” is now followed by a majority of circuits. The Second Circuit specified five theories of agency and contract law under which signatories to an agreement with an arbitration provision may compel a non-signatory to arbitrate; an analysis of each theory follows.

A. Incorporation By Reference

Incorporation by reference occurs when a contract between two parties explicitly incorporates another contract. “A nonsignatory may compel arbitration against a party to an

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arbitration agreement when that party has entered into a separate contractual relationship with the nonsignatory which incorporates the existing arbitration clause.”134 For example, in *Upstate Shredding, LLC v. Carloss Well Supply Co.*,135 the U.S. District Court for the Northern District of New York compelled a non-signatory to arbitrate because the arbitration provision was broad enough to allow a non-signatory’s disputes within its terms and the agreement with the non-signatory explicitly referred to the agreement containing an arbitration provision.

B. **Assumption**

A non-signatory may be bound by an agreement to arbitrate as a result of its conduct. “In the absence of a signature, a party may be bound by an arbitration clause if its subsequent conduct indicates that it is assuming the obligation to arbitrate.”136 For example, in *Gvozdenvic v. United Airlines*,137 where a non-signatory participated in an arbitration, the court held that the party had assumed the obligation to arbitrate.

C. **Agency**

As noted in *Thomson*,138 traditional theories of agency may bind a non-signatory to an arbitration agreement. A non-signatory principal may be bound to arbitrate where its agent signed the agreement providing for arbitration on its behalf.

D. **Piercing the Corporate Veil or Alter Ego**

In general “a corporate relationship alone is not sufficient to bind a non-signatory to an arbitration agreement.”139 A court will not bind a non-signatory entity to arbitrate unless it is so intertwined with a signatory that a court is justified in piercing the corporate veil. The standard for piercing the corporate veil is fact sensitive and varies from jurisdiction to jurisdiction.

E. **Estoppel**

When the parties are closely related and the claims are “intimately founded in and intertwined with a franchise agreement with an arbitration provision a party is equitably estopped from avoiding arbitration of its claims.”140 In *Cash Converters USA, Inc. v. Burns*,141 a non-signatory guarantor was compelled to arbitrate because his claims were “inextricably intertwined with the franchise agreement” which contained an arbitration provision.

134 *Thomson-CFS, S.A.*, 64 F.3d at 777.


137 *Gvozdenvic v. United Airlines*, 933 F.2d 1100 (2d Cir. 1991).

138 *Thomson-CFS, S.A.*, 64 F.3d at 777.


Although not applied as often as the theories in *Thomson*, courts have compelled a non-signatory to arbitrate if it is interconnected, intertwined and inextricably linked to the transactions and the signatory, even without a finding that the corporate veil can be pierced.\(^{142}\) For example, in *Dighello v. Busconi*,\(^ {143}\) the court held that the fact that related corporations were not signatories to an agreement did not preclude them from being bound by an arbitration award. The related corporate entities’ actions were “clearly intertwined” and the ownership and officers were connected to the party to the agreement. In addition, the court said, “[a]ny issue that is ‘inextricably tied up with the merits of the underlying dispute’ may properly be decided by the arbitrator.”\(^ {144}\)

### VIII. NON-PARTIES COMPELLING SIGNATORIES TO ARBITRATE

Non-signatories also have attempted to compel arbitration under franchise agreement arbitration clauses. For example, a franchisee may sue under a franchise disclosure law, such as the California Franchise Investment Law, an individual corporate officer who “materially aids in the act or transaction constituting a violation” by purportedly providing improper earnings claims to the franchisee before the franchise agreement is signed.\(^{145}\) The corporate officer may want to resolve the matter in arbitration and therefore seek to compel arbitration. The same issue arises if the franchisee sues a company affiliated with a franchisor, and the affiliate wants the matter arbitrated.

The test to determine if a non-signatory may compel a signatory to arbitrate differs from the test for a signatory to compel a non-signatory to arbitrate. A non-signatory to an agreement containing an arbitration provision may compel a signatory to that agreement to arbitrate when the claims against the non-signatory are directly related to the non-signatory’s relationship to a signatory. In *Zaks v. TES Franchising*,\(^ {146}\) a franchisee was required to arbitrate its claims against a non-signatory CEO of the franchisor and a third-party company. The franchisee sued alleging fraud and violations of the Connecticut Unfair Trade Practices Act and Maryland Franchise Registration and Disclosure Act and the defendant-franchisor and non-signatories to the franchise agreement moved to compel arbitration. The court granted the motion, finding that the claims were directly related to the non-signatories’ relationship with the franchisor. In addition, the court held that “limitations observed in *Thomson* are inapplicable where, as here, ‘it is the non-signatory that seeks to invoke the arbitration clause.’”\(^ {147}\)

In the U.S. Court of Appeals for the Eighth Circuit, a non-signatory can compel a signatory to arbitrate when: 1) the relationship between signatory and non-signatory is so close that they are intertwined, or 2) the parties must rely on the agreement in asserting their claims

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\(^{142}\) See, i.e., *Long v. Silver*, 248 F.3d 309 (4th Cir. 2001) (compelling arbitration when a court found “little difference between a parent and subsidiary”); see also *Lefkovitz v. Wagner*, 291 F.Supp.2d 764 (N.D.Ill. 2003) (compelling arbitration when all the parties involved “owned or controlled the assets which [were] the subject of [the] arbitration”).


\(^{144}\) *Id.* at 87.


\(^{147}\) *Id.* at *7 (internal citations omitted).
against the signatories. In *CD Partners, LLC v. Jerry W. Grizzle*, a franchisee sued the principals of a bankrupt franchisor in Iowa state court. The principals removed the matter to federal district court and moved to compel arbitration. The district court denied the motion because the principals were not parties to the franchise agreement arbitration clause.

The Eighth Circuit reversed, holding that the principals were intertwined with the franchisor because: 1) the relationship of the non-signatories, as corporate officers, was a close one; 2) the alleged torts arose out of the principals’ conduct as officers; and 3) the “[e]visceration of the underlying arbitration agreement would be avoided only by allowing the three principals to invoke the arbitration agreement.” The Eighth Circuit also found that the franchisee’s claims against the three principals “presume the existence for the written agreement between the two corporations.”

The U.S. District Court for the Southern District of Texas took a slightly different approach in *Juna Miron v. Maro Sloan*, declaring that non-signatories can compel arbitration when: 1) a signatory relies on the terms of the written agreement in asserting its claims against the non-signatory, and 2) a signatory raises allegations that are substantially interdependent and there is concerted conduct by the non-signatory and one or more signatories. The district court found that the plaintiff’s claims were intertwined with the franchise agreement containing the arbitration provision and that the allegations against the non-signatory were intertwined and interconnected with the conduct of the signatory.

**IX. THE ARBITRAL VENUE**

Litigation about arbitration frequently involves a struggle over where an arbitration should take place. Notwithstanding the cost of enforcing a chosen arbitral venue, it is clear that most franchisors strongly prefer to have all arbitrations conducted in their home venue or at one central location and are willing to expend the time and resources necessary to secure their chosen arbitral venue. At the same time, franchisees continue to argue that, whatever the contract says, they should not be forced to travel far distances and otherwise incur avoidable expenses to arbitrate their claims. Further complicating the issue, a wide number of state franchise registration-disclosure and relationship laws attempt to dictate the appropriate venue for adjudicating a resident franchisee’s state law claims.

Under the FAA, the purported waiver of state statutory rights is not the same as the waiver of federal statutory rights. To the extent that a state law expressly provides that a court is the appropriate forum for deciding a claim, the FAA preempts that statutory provision. In *Southland Corp. v. Keating*, the U.S. Supreme Court held that the FAA preempted a limitation on arbitration imposed by the California Franchise Investment Law, which required judicial consideration of claims brought under the state statute. The Court further explained that the FAA “not only ‘declared a national policy favoring arbitration,’ but actually ‘withdrew the power of the states to require a judicial forum for the resolution of claims which the contracting parties agreed to

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149 *Id.* at 799.
150 *Id.* at 799.
resolve by arbitration." Since Southland Corp. v. Keating, the cases are legion in which courts upheld the validity of franchise agreement arbitration clauses requiring franchisees to arbitrate outside their home states.\textsuperscript{154}

While the FAA’s mandate is clear, franchisee arguments contra the chosen arbitral venue maintain an ever present potential to resonate.\textsuperscript{155} Indeed, several franchisees have defeated, in whole or in part, franchise agreement arbitral forum selection clauses, by using an array of contractual defenses. Perhaps the most interesting is no “meeting of the minds” – a defense predicated upon a conflict between the franchise agreement and the franchisor’s disclosure documents, particularly with regard to dispute resolution and the franchisor’s intentions should dispute resolution become necessary.\textsuperscript{156}

X. SELECTING THE ARBITRATION ADMINISTRATOR

Another issue that can arise is whether a party can pursue arbitration before an administrator, such as JAMS or the AAA, where the arbitration agreement expressly provides for administration before, or pursuant to the rules of, a different ADR provider.

Under Section 5 of the FAA:

“If in the agreement provision be made for a method of naming or appointing an arbitrator or arbitrators or an umpire, such method shall be followed; …”\textsuperscript{157}


\textsuperscript{154} See Bradley v. Harris Research, Inc., 275 F.3d 884, 889 (9th Cir. 2001) (upholding validity of arbitration clause in franchise agreement that provided for California franchisee to arbitrate in Utah finding that California statute providing that “[a] provision in a franchise agreement restricting venue to a forum outside this state is void” is unenforceable since it is not a generally applicable contract defense that applies to any contract, but only to forum selection clauses in franchise agreements."); KKW Enterprises, Inc. v. Gloria Jean’s Gourmet Coffees Franchising Group, 184 F.3d 42, 50-52 (1st Cir. 1999); Doctor’s Assoc., Inc. v. Hamilton, 150 F.3d 157, 163 (2d Cir. 1998), cert. denied, 525 U.S. 1103 (1999); Management Recruiters Int’l v. Bloor, 129 F.3d 851, 856 (6th Cir. 1997).

\textsuperscript{155} See, e.g., Laxmi Invs., LLC v. Golf USA, 193 F.3d 1095, 1097 (9th Cir. 1999) (finding no meeting of minds as to forum selection provision which offering circular stated that California law required California forum for franchise agreement dispute resolution, and that out-of-state forum provision might not be enforceable under California law). But see Gingiss Int’l Inc. v. L&H Tuxes, Inc., Bus. Franchise Guide (CCH) ¶ 12,372 (N.D.Ill. 2002) (where a California franchisee argued that it should be permitted either to litigate or to arbitrate in California, rather than Illinois, the court criticized and distinguished Laxmi and found that entirety of the franchisee’s claims under both a development agreement and a franchise agreement were arbitrable).

\textsuperscript{156} See, i.e., Laxmi Invs., LLC v. Golf USA, 193 F.3d at 1097; Alphagraphics Franchising, Inc. v. Whaler Graphics, Inc., 840 F.Supp. 708, 711 (D.Ariz. 1993) (holding in part that there was no meeting of minds as to forum selection portion of arbitration clause notice provided with franchise agreement where notice stated that clauses inconsistent with Michigan law would not be enforceable and where Michigan law purported to prohibit out-of-state forums). See also Cohen v. Stratis Business Centers, Inc., 2005 WL 3008807 (D.N.J. 2005) (granting motion to compel, but concluding that franchisees should not be bound to contractual choice of forum and case should be arbitrated in New Jersey).

Thus, what arbitration organization may administer a case is a question of “interpretation and construction” governed by federal law.\footnote{See In re Salomon Inc. S’holders’ Derivative Litig. (Weiner v. Gutfruend), 68 F.3d 554, 559 (2d Cir. 1995); Norman S. Poser, Making Securities Arbitration Work, 50 SMU L. Rev. 288, 321 (1996) (“The question of interpreting choice-of-forum clauses in agreements covered by the FAA is governed by federal law.”).}

In Smith Barney Inc. v. Critical Health Sys. of N.C. Inc. of Raleigh, N.C., Critical Health and Smith Barney were parties to an arbitration agreement which provided that: “[a]ny controversy arising out of or relating to any of my accounts ... shall be settled by arbitration, in accordance with the rules then in effect of the NASD, or the Boards of Directors of the NYSE or the American Stock Exchange, Inc.” When Critical Health initiated an arbitration before the AAA, Smith Barney sought to stay the proceedings as improperly filed. In response, Critical Health maintained that the agreement to arbitrate did not specify the exclusive fora for arbitration, but only required that the “rules” of the NASD, NYSE, or AMEX be followed in any arbitration. The U.S. Court of Appeals for the Fourth Circuit disagreed:

This argument, however, contravenes the plain language of the contract. The agreement provides that “[a]ny controversy arising out of or relating to any of my accounts ... shall be settled by arbitration, in accordance with the rules then in effect of the NASD, or the Boards of Directors of the NYSE or the American Stock Exchange, Inc.” The agreement specifies that arbitration may take place according to the rules of three SROs [self-regulatory organizations]. It does not mention any other organization and does not specifically provide for arbitration before the AAA. Under the principle of \textit{expressio unius est exclusio alterius}, arbitration is limited to the three prescribed fora.

* * *

Here the agreement provides that arbitration will proceed in accordance with the rules of the three SROs [, the NYSE, NASD, and AMEX].... Where the parties have agreed explicitly to settle their disputes before particular arbitration fora, that agreement must control.... To hold otherwise would require us to impose a strained construction on a straightforward agreement. It is far better to interpret the agreement based on what is specified, rather than attempt to incorporate other remote rules by reference. Here [the investor] has the choice of three fora. We can see no reason to pass over the three specified fora and allow arbitration to proceed in a fourth unspecified arena.\footnote{Smith Barney, supra, F.3d at 861-863. Disallowing arbitration before a unilaterally chosen administrator contrary to an agreement is also consistent with the doctrine of \textit{inclusio unius est exclusio alterius}, or the “inclusion of one is the exclusion of another.” Black’s Law Dictionary 763 (6th ed., West 1990). Under this doctrine of construction, the “certain designation of one person is an absolute exclusion of all others.” \textit{Id.} See also Baughman v. Freienmuth, 343 F.Supp. 487, 490 (D.Md. 1972), aff’d in part, rev’d in part on other grounds, 478 F.2d 1345 (4th Cir. 1973).}

Other federal courts also have rejected the unilateral selection of ADR providers when they are not specified in the parties’ arbitration agreement.\footnote{See, e.g., In re Salomon Inc. S’holders’ Derivative Litig. (Weiner v. Gutfruend), 68 F.3d 554 (2d Cir. 1995); Luckie v. Smith Barney, Harris Upham & Co., Inc., 999 F.2d 509 (11th Cir. 1993); Merrill Lynch, Pierce, Fenner & Smith, Inc. v. Georgiadis, 903 F.2d 109 (2d Cir. 1990) (concluding that there was no real...
XI. INJUNCTIONS OUTSIDE ARBITRATIONS

Both franchisors and franchisees sometimes seek injunctions from a court before, or in aid of, arbitration. The most common examples for franchisors are injunctions 1) to protect a trademark, 2) to enforce system standards, and 3) to enforce restrictive covenants. Franchisees may seek injunctive relief from a court 1) to stay termination and maintain the status quo during arbitration and 2) protect an exclusive territory or dealership.

Although a party can obtain injunctions in arbitration, there are several reasons why it may instead turn to the court system. A party may seek injunctive relief to stop an immediate harm that is occurring while an arbitration is proceeding, for example, to stop an imminent termination. In addition, it may be necessary to seek preliminary injunctive relief outside the arbitration because of a delay in selecting an arbitrator. If, during this time, a franchisor is being harmed, for example, by a franchisee’s continued use of its trademark, a franchisor may turn to the courts for a preliminary injunction in aid of the arbitration.

Franchisors frequently include franchise agreement provisions that specifically except from the agreement’s arbitration clause disputes involving the franchisor’s trademark and interim and post-term restrictive covenants. For example, in Quizno’s Master, LLC, v. Shane Kadriu, although the parties’ franchise agreement required arbitration, the franchisor sued to enjoin a franchisee from its continued use of a trademark after the agreement was terminated. Even though the franchisee responded by alleging fraud in the inducement, an issue that was required to be arbitrated, the court granted the preliminary injunction, finding that the franchisor was likely to succeed on the merits.

Even without an express reservation of the right to pursue court action for injunctive relief, a court may still consider and grant that relief if a franchisee can establish that it will suffer irreparable harm. For example, in Rothman v. Re/Max of NY, Inc., a real estate franchisee moved the court to enjoin a franchisor from terminating the franchise while an arbitration was pending. In granting the injunction, the court noted that “money damages after trial would not be adequate substitute for uninterrupted continuation of the franchise.”

Franchisees can and should file similar motions to protect exclusive territories if there is a likelihood that the loss of that exclusivity will cause irreparable injury. These motions may, however, be denied where the parties’ agreement contains a broad arbitration clause. This was the result in Drillot Corp. v. BSH Home Appliance Corp., where a dealer moved to enjoin the

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difference between an agreement that provided for arbitration “only before” a specified SROs, and an agreement that provided for arbitration ‘in accordance with the rules of several SROs’; PaineWebber Inc. v. Rutherford, 903 F.2d 106 (2d Cir. 1990) (concluding that the arbitration clause should be read as an agreement to arbitrate before one of the specified securities self-regulatory organizations (“SROs”) (NASD, NYSE, or AMEX), not before the AAA, where Rutherford had unilaterally decided to file); Conroy v. Merrill Lynch, Pierce, Fenner & Smith, Inc., 899 F.Supp. 1471 (W.D.N.C. 1995); Weiner v. Smith Barney, Inc., No. CV 95-1897 DT, slip op. (C.D.Cal. May 22, 1995); Merrill Lynch, Pierce, Fenner & Smith, Inc. v. King, 804 F.Supp. 1512 (M.D.Fla. 1992); PaineWebber Inc. v. Pitchford, 721 F.Supp. 542 (S.D.N.Y. 1989), aff’d sub nom, PaineWebber, Inc. v. Rutherford, 903 F.2d 106 (2d Cir. 1990).


manufacturer from selling to its customers in violation of an exclusive distributorship agreement. In denying the motion, the Georgia federal court recognized that “it is not clear under federal law whether district courts have the power to grant injunctive relief to a party when arbitration has been initiated,” but noted that the broad arbitration provision called for arbitration of all disputes.

XII. INJUNCTIVE RELIEF IN ARBITRATIONS

Before the arbitrator is selected, parties are typically required to seek provisional interim relief from the courts. However, after an arbitrator is appointed, the arbitrator may issue orders for injunctive and other provisional remedies.165

The first hurdle in obtaining injunctive or other interim relief from arbitrators is often persuading them that they have the authority to grant that relief. Under Rule 35 of the AAA Commercial Arbitration Rules (the “AAA Rules”):

(a) The arbitrator may take whatever interim measures he or she deems necessary, including injunctive relief and measures for the protection or conservation of property and disposition of perishable goods.

(b) Such interim measures may take the form of an interim award, and the arbitrator may require security for the costs of such measures.

(c) A request for interim measures addressed by a party to a judicial authority shall not be deemed incompatible with the agreement to arbitrate or a waiver of the right to arbitrate.

Similarly, interim injunctive relief is available under the JAMS rules.166 Like Rule 35 of the AAA Rules, JAMS Rule 24(e) provides that:

[T]he Arbitrator may take whatever interim measures are deemed necessary, including injunctive relief and measures for the protection or conservation of property and disposition of disposable goods. Such interim measures may take the form of an interim Award, and the Arbitrator may require security for the costs of such measures. Any recourse by a Party to a court for interim or provisional relief shall not be deemed incompatible with the agreement to arbitrate or a waiver of the right to arbitrate.167

Once the arbitrators recognize that they have the authority to grant interim relief, they generally apply the traditional judicial standard for issuing a preliminary injunction. Accordingly, the party seeking relief should be ready to demonstrate a likelihood of success on the merits and that absent injunctive relief irreparable harm will be suffered.

166 See JAMS Rule 24 (2002).
167 JAMS Rule 24(e) (2002).
XIII. MOTIONS TO CONFIRM OR VACATE ARBITRATION AWARDS

Section 9 of the FAA states that an arbitration award must be confirmed within one year after it issues. The court’s function in confirming an arbitration award is limited. The court “must grant such an order unless the award is vacated, modified, or corrected as prescribed in sections 10 and 11” of the FAA. As the case law described below (much of it not in franchise cases) indicates, vacating an arbitration award is a difficult undertaking: although the bases to vacate an award exist in theory, cases demonstrating their applicability are rare.

Section 10 of the FAA empowers a court to vacate an arbitrator’s award where: 1) the award was procured by corruption, fraud, or undue means; 2) there was evident partiality or corruption by the arbitrators; 3) there was arbitrator misconduct; or 4) the arbitrator exceeded his powers. However, courts will only set aside arbitrators’ awards in “very narrow circumstances.” Courts afford a “final arbitration award an ‘extraordinary level of deference’ and [are] not authorized to review the merits of the award even when parties allege that the award rests on serious error.”

The traditional bases for vacating an arbitrator’s award are addressed below.

A. Result Procured by Corruption, Fraud, or Undue Means

Under the FAA, to establish that an arbitrator’s award was procured by fraud, a party must demonstrate by clear and convincing evidence conduct that materially relates to an issue involved in the arbitration, and could not have been discovered by due diligence before or during the arbitration. There must be a nexus between the alleged fraud and the basis for the panel’s decision. “Undue means” warranting a vacatur of an arbitration award requires proof of intentional misconduct; it includes measures equal in gravity to bribery, corruption, or physical threat to an arbitrator, and does not apply to the submission of evidence that is merely legally objectionable.

In Int’l Bhd. of the Teamsters, Local 519 v. United Parcel Serv., the Teamsters argued that UPS fraudulently procured an arbitration award by coercing a witness to testify falsely. The U.S. Court of Appeals for the Sixth Circuit, finding that the false testimony was materially related to the issues in the arbitration, remanded the case with instructions to the district court to analyze whether the remaining elements for vacating an award procured by fraud existed.

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169 Amicizia Societa Navegazione v. Chilean Nitrate & Iodine Sales Corp., 274 F.2d 805 (2nd Cir. 1960); G.C. and K.B. Invs., Inc. v. Wilson, 326 F.3d 1096, 1105 (9th Cir. 2003) (stating that “[c]ourts have interpreted sections 9 and 10 narrowly.)


B. **Evident Partiality or Corruption of the Arbitrator**

In *Doctor’s Assoc., Inc. v. Jasvir Dhaliwal*, the franchisee moved to vacate an arbitrator’s award based on, among other things, the fact that the arbitrator failed to disclose prior arbitration awards in favor of the franchisor. The franchisee argued that the arbitrator’s previous awards reflected partiality. The court noted that the franchisee failed to raise the issue before the award and denied the motion to vacate. This begs the question of whether the result would have been different had the franchisee raised (and thus preserved) the objection at an earlier stage of the case.

The franchisee in *Choice Hotels Int’l, Inc. v. Chewl’s Hospitality, Inc.*, argued that the arbitrator demonstrated evident partiality in favor of the franchisor, the district court rejected this argument, and the Fourth Circuit affirmed, concluding that the franchisee offered no evidence of bias. The Fourth Circuit analyzed the award in light of the franchisor’s damage claims and pointed out that the arbitrator awarded less in liquidated damages than the franchisor sought and also did not treble damages on the Lanham Act trademark infringement claim.

C. **Arbitrator Misconduct**

Misconduct warranting the setting aside of an arbitration award must amount to a denial of fundamental fairness of the arbitration proceeding. Even on a clear showing of misconduct, the party seeking to vacate an arbitration award has to show that it was deprived of a fair hearing.

The U.S. Court of Appeals for the Fifth Circuit held that an arbitrator’s *ex parte* receipt of evidence was misconduct, in *Totem Marine Tug & Barge, Inc. v. North American Towing, Inc.* After the close of the hearing, one of the arbitrators called North American’s counsel to obtain earnings figures and adopted these figures. Upon learning of the telephone call, Totem immediately moved to vacate the award. The district court denied the motion, but the Fifth Circuit reversed and vacated the award, explaining that “[t]he ex parte receipt of evidence bearing on this matter constituted misbehavior by the arbitrators prejudicial to Totem’s rights in violation of [Section 9 of the FAA].”

Additionally, an arbitrator’s failure to postpone a hearing when a party serves an amended claim on the day before the hearing, is misconduct. In *Coastal Gen. Constr. Serv., Inc. v. Virgin Islands Housing Auth.*, the government agency respondent requested a postponement of a hearing to investigate an amended claim served the day before the hearing. The arbitrator refused despite the fact that the AAA rules specifically allowed the postponement. Over the objection of the government agency the arbitrator held a hearing and awarded damages on the amended claim. The government moved to vacate the award. The Virgin Island territorial court vacated the award and a three judge panel of the district court affirmed.

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178 *Id.* at 653.

D. The Arbitrator Exceeded Powers

Arbitrators exceed their authority when they render an award on matters that the parties did not submit to arbitration. In *Totem Marine Tug & Barge, Inc. v. North American Towing, Inc*, cited above, the arbitrators awarded damages on a claim not presented, even though the party who received the award conceded that the matter was not at issue. The court vacated the award, stating that "the arbitrators ignored the arbitral dispute submitted by the parties and dispensed their 'own brand of industrial justice.'"180

Arbitrators do not exceed their authority when they exclude a party from an arbitration proceeding for failure to comply with the rules of the governing arbitration body. In *Choice Hotels, Int'l Inc. v. Niteen Hotels (Rochester) LLC*,181 a franchisee failed to follow the AAA rules requiring that it identify its designated representative in advance of the hearing. The arbitrators excluded the representative from the proceeding and after hearing the franchisor's evidence issued an award in favor of the franchisor. The franchisee moved to vacate, but the district court denied the motion and the Fourth Circuit affirmed.

E. Court Developed Bases

As outlined in *Twin Cities Galleries v. Media Arts*,182 courts recognize three additional grounds for vacating an arbitration award beyond those enumerated in FAA § 10: (1) the award is 'completely irrational'; (2) the award evidences manifest disregard for the law; and (3) the award "expressly conflicts with a 'well defined and dominant public policy.'"183

Although denying the motion to vacate, the court in *C. McGrann v. First Albany Corp.*,184 defined an award as completely irrational when the award fails to draw its essence from the agreement. The court stated that "[a]n arbitration award draws its essence from the agreement if the award is derived from the agreement, viewed in light of the agreement's language and context, as well as other indications of the parties' intention."185

On manifest disregard claims, "mere errors of law do not provide justification for vacating an arbitral award."186 In *Doctor's Associates, Inc. v. Quinn*,187 the court explained that manifest disregard is "more than an error or misunderstanding of the law; it is a refusal to apply legal principles known to the arbitrators, or ignoring explicit, definite and clearly applicable law."188

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180 *Totem Marine Tug & Barge*, 607 F.2d at 652 (internal citations omitted).
183 *Id.* at 975.
184 *C. McGrann v. First Albany Corp.*, 424 F.3d 743 (8th Cir. 2005).
185 *Id.* at 749.
188 *Id.* at p. 2.
In *Choice Hotels Int'l v. Francisco Felizardo*, the court denied a motion to vacate an award granting a franchisee rescission of the franchise agreement. The franchisor argued that the arbitrator acted in manifest disregard of the law, but the court determined that the franchisor's arguments were essentially objections to the arbitrator's application of the law. The court held that even if the arbitrator misinterpreted the law, engaged in faulty legal reasoning, or came to erroneous legal conclusions, that did not constitute disregard for the law.

An arbitration panel did not manifestly disregard the law by considering extrinsic evidence to modify the plain meaning of a franchise agreement. In *Fielding v. Doctor's Associates., Inc.*, the franchisor moved to vacate asserting manifest disregard of the law. The franchise agreement contained a merger and integration clause, but the court found that the franchisee's allegations of fraud and unequal bargaining power justified the arbitrator's application of an exception to the general principle that extrinsic evidence is not allowed in such cases.

At least one court has vacated an award on manifest disregard grounds, when an arbitration panel used an incorrect theory of law as the basis for a damages calculation. In *Birmingham News Co. v. Horn*, the panel considered lost future profits and lost franchise value as distinct damages. The court disagreed, holding them duplicative and vacating the arbitration award.

In *Twin Cities Galleries v. Media Arts*, cited above, the district court vacated an arbitration award because it conflicted with public policy. The court reversed an arbitration panel's determination that the FAA preempted the Minnesota Franchise Act's anti-waiver law that would have rendered a California choice of law unenforceable. In reaching its decision the district court reasoned that the "the laws and legal precedent of the state of Minnesota affirmatively establish an explicit, well defined and dominant public policy to protect Minnesota franchisees." In *Lapine Tech. Corp. v. Kyocera Corp.*, the Ninth Circuit held that "federal courts can expand their review of an arbitration award beyond the FAA's grounds, when (but only to the extent that) the parties have so agreed." Similarly, in *Gateway Tech., Inc. v. MCI Telecomm. Corp.*, the Fifth Circuit concluded that "[b]ecause these parties contractually agreed to expand judicial review, their contractual provision supplements the FAA's default standard of review and allows for de novo review of issues of law embodied in the arbitration award." Conversely, the Eight Circuit, citing to *Lapine Tech* and *Gateway Tech*,

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192 *Twin Cities Galleries*, 415 F.Supp. 2d at 975.
193 *Lapine Tech. Corp. v. Kyocera Corp.*, 130 F.3d 884 (9th Cir. 1997).
194 Id.
195 *Gateway Tech., Inc. v. MCI Telecomm. Corp.*, 64 F.3d 993, 997 (5th Cir. 1995).
observed that “we do not believe that it is yet a foregone conclusion that parties may effectively agree to compel a federal court to cast aside sections 9, 10, and 11 of the FAA.”

The court did, however, note that parties may “contract for an appellate arbitration panel to review the arbitrator’s award.”

In Chi. Typographical Union No. 16 v. Chi. Sun-Times, Inc, the Seventh Circuit held that parties “cannot contract for judicial review of [an arbitration] award; federal jurisdiction cannot be created by contract.”

Given the split in the circuit courts, the Supreme Court will ultimately have to rule on whether contracting parties can agree to expand judicial review of arbitration awards.

XIV. SOME DRAFTING CONSIDERATIONS FOR FRANCHISORS

Arbitration can materially change the dispute resolution “rules” that franchisees might ordinarily be accustomed to: there may be no right to a jury trial, pre-hearing discovery may be limited, class actions may be eliminated and judicial review of decisions is severely circumscribed. Therefore, in drafting arbitration clauses for use in franchise agreements, franchisors need to pay the utmost attention to the substance of the clause and its presentation and placement. Both the substance of what is said and, in some jurisdictions, the form of how it is presented, can affect whether the arbitration clause will be enforced by a court if challenged.

Additionally, although arbitration is generally favored as a matter of federal (and most state) public policies, some jurisdictions still manifest hostility to arbitration. Courts within these jurisdictions sometimes strain to exclude disputes from arbitration by construing the scope of an arbitration clause narrowly. These jurisdictions are also more likely to subscribe to a franchisee’s view that an arbitration clause is substantively and procedurally "unconscionable" and should not be enforced.

The following practice pointers are designed to increase the likelihood that a court will enforce the arbitration clause as written and a franchisor will be able to avoid class arbitration:

1. Draft a fair and visibly prominent arbitration clause;

2. Make sure that the arbitration clause expressly precludes a franchisee from participating in class arbitration or class litigation;

3. Consider whether to give new and renewing franchisees the unconditional right to reject the arbitration provision either at the execution of the franchise agreement and/or for some limited time thereafter, in exchange for consideration paid to the franchisor. This approach would make it far more difficult for any court to hold that the arbitration provision, including its class proceeding waiver, is procedurally unconscionable since it could no longer be argued that it was offered “take-it-or leave-it”;

4. Make sure that the arbitration clause authorizes the court and not the arbitrator to determine the validity and effect of any class action waiver. Many current arbitration clauses broadly delegate to the arbitrator not only the

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198 Id. at 998.

199 935 F.2d 1501, 1505 (7th Cir. 1991).
resolution of the underlying dispute but also the threshold question whether the dispute is arbitrable. Under *Green Tree Fin. Corp. v. Bazzle*,\(^{200}\) a claimant is now free to argue the invalidity of a class action waiver clause to the arbitrator and the arbitrator has the authority to determine whether the arbitration can proceed as a class action. Post-*Bazzle*, the franchise agreement should expressly eliminate the arbitrator's authority to rule on the enforceability of class arbitration bans and all other class proceeding matters;\(^{201}\)

(5) To prepare for the risk that an arbitration administrator may do an unforeseeable thing in the future, consider adding language disqualifying any administrator which adopts any policy or rule not honoring any provision in the arbitration clause;

(6) Consider whether to create an exception to the arbitration clause's severability language for any class waiver set forth in the arbitration provision so that if the class action waiver is invalidated, the entire arbitration clause will be held to be null and void; and

(7) Preserve the right to appeal the invalidation of the arbitration clause.

Given the dynamic recent case law pertaining to the enforceability of arbitration clauses discussed above, especially with regard to adhesion, unconscionability and class arbitration waivers, franchisors should reconsider the legal sufficiency of their standard form arbitration provisions. Full disclosure and careful drafting will go far in defusing fraud, unconscionability and other arguments against arbitration. Of course, continuing common sense and fair play will go even further.


\(^{201}\) The immediate effect that *Green Tree Fin. Corp. v. Bazzle* had upon arbitration clauses in franchise disputes can be seen in *Blimpie Int'l, Inc. v. Blimpie of the Keys*, 371 F.Supp.2d 469 (S.D.N.Y. 2005), where the franchisor sought to compel its subfranchisor to arbitrate its claims individually, rather than on a consolidated basis. In response, the subfranchisor moved to dismiss for failure to state a claim, arguing that it was for the arbitrator to decide whether the arbitration agreement permitted a consolidated arbitration proceeding. In granting the motion to dismiss, the court relied largely on *Green Tree Fin. Corp. v. Bazzle*, to hold that questions concerning whether the parties agreed to arbitrate a particular dispute, i.e., "gateway matters," are questions for the judge and questions concerning the type of arbitration proceedings the parties agreed upon, such as consolidation, are procedural questions for the arbitrator to decide.
APPENDICES
APPENDIX A

SAMPLE ARBITRATION CLAUSES
APPENDIX B

SAMPLE ARBITRATION ORGANIZATION RULES
APPENDIX C

SAMPLE CLASS ACTION ARBITRATION RULES
MICHAEL EINBINDER

MICHAEL EINBINDER is a founding member of Einbinder & Dunn, LLP and has been practicing law since 1981. Michael Einbinder is a participating member of the American Bar Association Forum on Franchising, and the Association of the Bar of the City of New York (Panel Memberships on Franchise Law, Commercial Law and Commercial Litigation). He is also a member of the American Association of Franchisees and Dealers, the International Franchise Association, and the American Franchisee Association where he has served on the Legal Symposium Steering Committee. Mr. Einbinder is a frequent speaker at legal and industry events on franchise issues and has written numerous articles and papers on franchising issues.
DEAN T. FOURNARIS

Dean Fournaris is a partner in the Philadelphia office of the law firm of Ballard Spahr Andrews & Ingersoll, LLP, where he is a member of the firm's Franchise and Distribution and Intellectual Property Practice Groups and Litigation Section. Mr. Fournaris handles commercial litigation and business transactions with emphasis on franchising, licensing and distribution matters involving national franchisors, licensors, manufacturers, distributors and area developers. His work covers franchise and distribution system development and litigation; franchise and distribution system contracts; franchise and distribution system standards; and food and product safety. Mr. Fournaris is a graduate of Franklin and Marshall College (B.A., 1988) and Cornell Law School (J.D., 1991).