Navigating *Nagrampa*:
Drafting and Contesting the Arbitration Clause

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NAVIGATING NAGRampa:
DRAFTING AND CONTESTING THE ARBITRATION CLAUSE

I. INTRODUCTION

For many years, franchisors have included arbitration clauses in their franchise agreements. Recently, many courts have declined to enforce arbitration clauses for various reasons. One of the most recent cases to follow this trend was the Ninth Circuit decision in Nagrampa v. MailCoups, Inc.\(^1\) This paper will discuss the cases that led up to Nagrampa; the Court’s ruling; selected court decisions on arbitration which cite Nagrampa; suggested ways to contest an arbitration clause and, conversely, suggestions for drafting arbitration clauses that would survive a Nagrampa-type analysis; and alternate dispute resolution methods in general.\(^2\)

II. COURT DECISIONS LEADING UP TO NAGRampa

Nagrampa’s antecedents include a number of employment actions involving mandatory arbitration clauses highlighted by the California Supreme Court decision in Armendariz v. Foundation Health Psychare Services, Inc.\(^3\), as well as the first franchisee action applying the Armendariz principles to arbitration provisions in a franchise agreement, Independent Association of Mail Box Center Owners v. Mail Boxes Etc. U.S.A., Inc. (“IAMCO”)\(^4\).

For decades arbitration agreements were almost universally enforced in California, and increasingly became more prevalent in employment and consumer contracts. Often the contracts were of a take it or leave it nature and sometimes were grafted onto an existing relationship by an employee handbook or a credit card insert announcing mandatory arbitration.

On August 24, 2000, the California Supreme Court rendered its twin holdings regarding mandatory arbitration provisions in Armendariz. The California Supreme Court held that asserted unconscionable provisions in mandatory arbitration clauses would be reviewed by a court, not by an arbitrator, in the first instance. The reason for this ruling was that valid arbitration agreements are enforceable “save upon such grounds as exist at law or in equity for revocation of contract. (9 U.S.C. §2, see also Code Civ. Proc. §1281.) In other words, under California law, as under federal law, an arbitration agreement may only be invalidated for the same reasons as other contracts.”\(^5\) Second, the arbitration clause was against public policy to the extent it failed to allow the plaintiffs to vindicate their public policy rights in five separate areas.\(^6\) This latter holding of Armendariz has substantial importance.

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\(^1\) 469 F.3d 1257 (9th Cir. 2006) (en banc).
\(^2\) This paper reflects the differing viewpoints of both a franchisor attorney and a franchisee attorney with different portions of this paper having been written by each of the authors. Each author accordingly does not agree with all statements in this paper. While certain statements in this paper are expressly qualified as the view of only one of the authors, other statements may also reflect the view of only one author.
\(^3\) 24 Cal. 4\(^{th}\) 83, 99 Cal. Rptr. 2d 745, 6 P.3d 669 (2000).
\(^4\) 133 Cal. App. 4\(^{th}\) 396, 34 Cal. Rptr. 3d 659 (2005). Mr. Lagarias was co-counsel for the franchisees, and Mr. Heller was co-counsel for the franchisor in that case. Mr. Lagarias also consulted with co-counsel for the plaintiff franchisees in the Nagrampa appeal.
\(^5\) 24 Cal. 4\(^{th}\) at 98.
\(^6\) Id. at 90-91, 102-113.
Armendariz involved statutory claims by an employee under the California Fair Employment and Housing Act ("FEHA") of employment discrimination and wrongful discharge. Any doubt as to the second holding is answered by Justice Mosk's opening remarks:

We conclude that such claims [FEHA] are in fact arbitrable if the arbitration permits an employee to vindicate his or her statutory rights. As explained, in order for such vindication to occur, the arbitration must meet certain minimum requirements, including neutrality of the arbitrator, the provision of adequate discovery, a written decision that will permit a limited form of judicial review, and limitations on the costs of arbitration.7

A remaining question was whether the twin rulings of Armendariz would apply to actions other than FEHA claims and particularly to any franchise law claims. Although Armendariz involved FEHA employment claims, the doctrine of unconscionability is a general contract law principle. Regarding its second holding, the California Supreme Court referenced vindication of public statutes and rights, particularly noting California Civil Code Section 3513 which provides that "Anyone may waive the advantage of a law intended solely for his benefit, but a law established for a public reason cannot be contravened by a private agreement."8

Between the time of the first ruling by the Ninth Circuit in Nagrampa and the subsequent en banc reversal, the California Court of Appeal applied the Armendariz principles to franchisee statutory claims in IAMCO. While the plaintiffs there were not generally seeking to void the entire arbitration provision, the Court of Appeal held that bans on punitive damages and class and group actions were unconscionable.9 In addition, the Court of Appeal held that the plaintiff franchisee statutory claims under the California Franchise Investment Law ("CFIL")10, the Uniform Trade Secrets Act11 and the Unfair Competition Law12 affect the public interest and therefore appear to come under the rules of Armendariz.13 The Court of Appeal further found that plaintiff franchisees made a prima facie showing that their claims warranted advance fee allocation, but remanded the issue to the trial court for determination.14

III. THE NAGRAMPA DECISION

A. Summary of the Case

In Nagrampa, the Ninth Circuit, sitting en banc, applied California law to invalidate an arbitration provision in a franchise agreement on the grounds that it was procedurally and substantively unconscionable. The Court held that the provision was procedurally unconscionable because the franchisor had overwhelming bargaining power, drafted the contract, and presented it to the franchisee on a take-it-or-leave-it basis. The Court held that

7 Id. at 90-91.
8 Id. at 100.
9 133 Cal. App. 4th at 406-413.
10 Corp. Code § 16700 et. seq.
11 Civil Code § 3426 et. seq.
12 Bus. & Prof. Code § 17200 et. seq.
13 133 Cal. App. 4th at 416.
14 Id. at 417.
the provision was substantively unconscionable because, among other things, it: (i) lacked mutuality by reserving to the franchisor the right to bring certain actions against the franchisee in court, while limiting the franchisee’s right to bring actions against the franchisor to the arbitral forum; and (ii) contained a forum selection clause designating the franchisor’s home state as the situs for arbitration, which location was found to be oppressive to the franchisee.

1. The Basic Facts

On August 24, 1998, Connie Nagrampa ("Nagrampa") entered into a franchise agreement with MailCoups, Inc. ("MailCoups") to establish and operate a MailCoups franchise in Contra Costa County in Northern California. The franchise agreement contained a provision requiring the parties to arbitrate, in accordance with the rules of the American Arbitration Association ("AAA"), any dispute that arose out of, or related to, the franchise agreement. The arbitration provision further provided:

[T]his clause shall not be construed to limit MailCoups’ right to obtain any provisional remedy, including, without limitation, injunctive relief from any court of competent jurisdiction, as may be necessary in MailCoups’ sole subjective judgment, to protect its Service Marks and proprietary information. ... The situs of the arbitration proceeding shall be the regional office of the American Arbitration Association which is located in Boston, Massachusetts. The costs of arbitration shall be borne equally by MailCoups and Franchisee. Each party shall be responsible for the fees and expenses of its respective attorneys and experts.

In September 2000, Nagrampa unilaterally terminated the franchise agreement after two years of unprofitable operation. In December 2001, MailCoups initiated arbitration proceedings claiming that at the time Nagrampa terminated the agreement, she owed MailCoups in excess of $80,000 in fees. MailCoups initially designated Los Angeles, California as the hearing locale.

Nagrampa objected to the arbitration proceeding, asserting "serious concerns about the validity of the arbitration clause."\(^{15}\) She further objected to the venue selection, requesting that the venue for the arbitration be Contra Costa, California, the county in which Nagrampa operated her MailCoups franchise. Finally, she objected to the arbitration fee clause. Based on these objections, as well as the AAA’s eventual determination that the hearing would take place in Boston, Nagrampa refused to participate in the arbitration proceedings.\(^{16}\)

Instead, Nagrampa filed suit in Superior Court of the State of California against MailCoups and the AAA, challenging the enforceability of the arbitration provision, among other things. Elsewhere in her complaint Nagrampa sought damages for fraud and violation of the CFIL but did not expressly seek to have the franchise agreement as a whole invalidated or declared unenforceable.

On January 14, 2003, MailCoups removed the action to the United States District Court for the Northern District of California, based on diversity of citizenship. MailCoups thereafter filed a motion to compel arbitration and dismiss or stay Nagrampa’s action, alternatively seeking transfer of the action to the United States District Court for the District of Massachusetts.

\(^{15}\) 469 F.3d at 1265-66.
\(^{16}\) Id. at 1266.
The district court glossed over the question of whether the arbitration provision was procedurally unconscionable and concluded that procedural unconscionability was not a dispositive issue for a motion to compel arbitration. The district court only addressed one issue: whether the arbitration provision was substantively unconscionable. It found that the provision was both valid and enforceable. Furthermore, because it found that the parties agreed to arbitrate in Boston, Massachusetts, it dismissed the action, permitting MailCoup to move in the District Court for the District of Massachusetts to compel arbitration.

Nagrampa appealed. Initially, a three-judge panel of the Ninth Circuit affirmed the district court’s holding, although on different grounds. Nagrampa then sought *en banc* review of the panel’s decision.

As an initial matter, the Ninth Circuit confronted the question of whether a court or an arbitrator should determine the validity of an agreement to arbitrate. Unless the challenge is to the validity of a contract as a whole, the Court held, the issue of the validity of an arbitration provision is for a court to decide. Finding that Nagrampa’s challenge was specifically, and only, to the validity of the arbitration provision, the Court concluded that it was the proper tribunal to decide that issue.

2. **Unconscionability Generally**

The Ninth Circuit observed that, in assessing an unconscionability claim, California courts analyze the contract provisions for both procedural and substantive unconscionability. In California, the Court further noted, the prevailing view is that procedural and substantive unconscionability need not both be present to the same degree. Instead, a sliding scale is applied: the more substantively oppressive the contract term is, the less evidence of procedural unconscionability is required to conclude that the term is unenforceable, and *vice versa*.

3. **Procedural Unconscionability**

Turning first to the issue of procedural unconscionability, the Ninth Circuit observed that, under California law, the critical factor in a procedural unconscionability analysis is usually the manner in which the contract or the disputed clause was presented and negotiated.

Noting that California courts have long recognized that franchise agreements have some characteristics of contracts of adhesion because of the allegedly vastly superior bargaining strength of the franchisor, the Court concluded that MailCoup had overwhelming bargaining power, drafted the contract, and presented it to Nagrampa on a take-it-or-leave-it basis.

The Court next considered the argument that Nagrampa had available to her “other franchise opportunities.” The Ninth Circuit found that:

The California Court of Appeal has rejected the notion that the availability in the marketplace of substitute employment, goods, or

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17 *Id.* at 1277-78.
18 *Id.* at 1277. The Ninth Circuit also held that plaintiffs may include, indeed are required under California law to include, other substantive contractual and statutory claims besides challenging the arbitration clause. *Nagrampa*, 469 F.3d at 1275, n.4.
19 *Id.* at 1280.
services alone can defeat a claim of procedural unconscionability. [Citations omitted.] The potential availability of other franchise opportunities alone does not defeat Nagrampa’s claim of procedural unconscionability.  

Similarly, the Court ruled that “the sophistication of a party, alone, cannot defeat a procedural unconscionability claim.” Acknowledging that the evidence of procedural unconscionability appeared minimal, the Court went on to analyze substantive unconscionability.

4. Substantive Unconscionability

The Court found that two provisions set forth in the arbitration clause were substantively unconscionable.

First, the Court noted that the contract gave MailCoup’s access to a judicial forum to obtain provisional remedies to protect its intellectual property, while it restricted Nagrampa to the arbitral forum to resolve any of her claims. The Court observed that where the party with stronger bargaining power has restricted the weaker party to the arbitral forum, but reserved for itself the ability to seek redress in either an arbitral or judicial forum, California courts have found lack of mutuality supporting a finding of substantive unconscionability. In this connection, the Court pointed out that the arbitration provision itself stated the business justification for excluding from arbitration MailCoup’s right to obtain provisional relief: “to protect its Service Marks and proprietary information.” The Court noted that “California courts routinely have rejected this justification as a legitimate basis for allowing only one party to an agreement access to the courts for provisional relief.”

Second, the Court noted that the arbitral forum was designated as Boston, Massachusetts, a location considerably more advantageous to MailCoup because its headquarters are in that vicinity. Under California law, the Court noted, if the place and manner restrictions of a forum selection provision are “unduly oppressive,” or “have the effect of shielding the stronger party from liability,” the forum selection provision is unconscionable.

The Court thus concluded that the forum selection clause supported a finding of substantive unconscionability because the clause had no justification other than as a means of maximizing MailCoup’s advantage over Nagrampa. The Court found that the prohibitive costs and burden of pursuing arbitration in Boston effectively precluded Nagrampa from ever raising claims against MailCoup.

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20 Id. at 1283.
21 Id.
22 Id. at 1281-84.
23 Id. at 1285-86.
24 Id. at 1287.
25 Id.
26 Id. at 1290.
5. **Court’s Other Bases for Denying Enforcement**

As an additional basis for finding the forum selection provision unenforceable, the Court noted that Section 20040.5 of the California Business and Professions Code provided that out-of-state forum selection provisions in franchise agreements were not enforceable under California law. As required by California Department of Corporations policy, MailCoup’s offering circular contained language noting that the forum selection clause might be unenforceable under California law. Applying a prior decision, *Laxmi Invs., LLC v. Golf USA*, the Court found no evidence that MailCoup ever indicated it would insist on an out-of-state forum in the face of contravening California law. The Court therefore concluded that Nagrampa had no reasonable expectation that the arbitration would take place in Boston.

The Court also found that the forum selection clause might also be unenforceable on public policy grounds because it impeded the enforcement of unwaivable or statutory rights. The Court concluded that because the forum selection clause could have forced Nagrampa to forgo unwaivable public rights because she might not pursue them due to the costs of arbitrating her claims in Massachusetts, it was contrary to California public policy and thus might be unenforceable.

Finally, the Court noted that to the extent a provision providing for the parties to split the cost of arbitration impedes the exercise of unwaivable, public interest statutory rights under California law, that provision may also be unenforceable. The Court relied on the decision of the California Court of Appeal in *IAMCO*, where the Court remanded the case to the trial court to determine the appropriate advance fee allocation to allow vindication of the plaintiff-franchisee’s rights under certain California statutes. Accordingly, the Court held that if Nagrampa were to make a *prima facie* showing that her statutory claims affect the public interest, she would be entitled to an advance fee allocation ruling to enable her to vindicate her statutory rights.

6. **Sliding Scale Test Tipped the Balance**

Applying California’s sliding scale test for unconscionability, the Court held that even though the evidence of procedural unconscionability was slight, the evidence of substantive unconscionability was strong enough to tip the scale and render the arbitration provision unconscionable and unenforceable. Two judges on the *en banc* panel wrote vigorous dissents, in which three of the other judges on the panel joined (at least in part), taking strong issue with the majority’s determinations regarding procedural and substantive unconscionability, as well as the conclusion that a court was the proper forum for deciding those issues.

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27 193 F.3d 1095 (9th Cir. 1999). In *Laxmi*, the Court of Appeals for the Ninth Circuit concluded that where the franchise offering circular contained language suggesting that the out-of-state forum selection and choice of law clauses may not be enforceable under California law, there was no “meeting of the minds” to a forum other than California. In such circumstances, the Court held that the franchisor could not establish that the parties had agreed to the out of state venue provision.

28 469 F.3d at 1290-91.

29 Id. at 1292.


31 469 F.3d at 1292.

32 Id.

33 Id. at 1293.
B. Case Law Since Nagrampa

Several cases decided since Nagrampa have addressed these types of arbitration issues.


In Net Global Marketing, Inc. v. Dialtone, Inc., Net Global, a marketing corporation, sued Dialtone, a telecommunications provider, for breach of a service agreement. The district court denied Net Global’s motion to dismiss or to compel arbitration finding that the arbitration agreement in the contract was unconscionable and unenforceable. Net Global appealed.

The Ninth Circuit Court of Appeals held that the district court was correct to invalidate the arbitration agreement because it was unconscionable. The Court of Appeals concluded that the district court’s finding that the arbitration provisions met California’s test for surprise was supported by substantial evidence. The Court found that the arbitration provisions appearing on page 12 of a 17 page document were not clearly disclosed, and a unilateral modification clause rendered the arbitration provision severely one-sided.

The Ninth Circuit opined that when the crux of the complaint is not the invalidity of the contract as a whole, the federal court -- and not the arbitrator -- must decide whether the arbitration provision is invalid and unenforceable. The Court further noted that state law requires the court to consider the circumstances surrounding the making of the entire agreement.

The Court concluded that the substantive and procedural unconscionability arguments required the Court to look at circumstances external to the arbitration agreement itself. As in Nagrampa, finding that none of the claims threatened to invalidate or otherwise directly affect the entire contract, the Court concluded that it was for the court -- not the arbitrator -- to assess the claims attacking the validity of the arbitration provision. The Court noted that this was the case, as in Nagrampa, “even if the substantive state law requires an examination of the making of the entire contract as part of [that] analysis [of the arbitration issue].”

Turning to a consideration of procedural unconscionability, the Court noted that either of two factors must be present: oppression or surprise. The Court found that Net Global could not point to any evidence indicating that it was faced with an “absence of reasonable market alternatives” in which an arbitration clause was not mandatory. Thus, Net Global could not show “oppression.”

However, the Court found that Net Global could demonstrate “surprise.” The Court noted that the clause was located at page 12 of a 17 page document that was “prolix”, was “drafted by the party seeking to enforce the disputed terms,” and was not presented to Net Global in print or in the same form as the rest of the contract. Thus, the arbitration provisions were not clearly disclosed. The Court found that the provisions were part of a long section headed “Miscellaneous” that lacked line breaks, there was no descriptive heading for the

34 No. 04-56685, 2007 U.S. App. LEXIS 674 (9th Cir. 2007).
35 Id. at 3, citing Nagrampa v. MailCoups, 469 F.3d at 1271.
provisions, and they were not initialed by either party leading to the conclusion that they could easily be overlooked. Therefore, the Court held that the arbitration provision was procedurally unconscionable. The Court noted, however, that the degree of unconscionability was “tempered” by the fact that Net Global is a commercial entity as opposed to an ordinary individual or “lay consumer”.  

The Court then looked at Dialtone’s arbitration clause with respect to the issue of substantive unconscionability. The Court refused to consider a limitation on liability in the “Terms of Service” in this context because it was not part of the arbitration clause. However, it found the unilateral right to modify the arbitration clause, and to craft an asymmetrical arbitration agreement, to be unconscionable under California law. The Court concluded that because the unilateral modification clause renders the arbitration provision “severely one-sided in the substantive dimension,” even moderate procedural unconscionability renders the arbitration agreement unenforceable.

2. **Jacquelin Davis v. O’Melveny & Myers**

*Jacquelin Davis v. O’Melveny & Myers,* came before the court on plaintiff Davis’ appeal of the district court’s order dismissing her action and compelling arbitration with her former employer, defendant O’Melveny & Myers. Davis challenged the enforceability of the arbitration agreement, contending that it was unconscionable under California law. The Court reversed and remanded, finding that the arbitration agreement was in fact unconscionable under California law.

Defendant O’Melveny adopted and distributed a new dispute resolution policy (“DRP”) containing a final and binding arbitration agreement for disputes for its employees. That policy was distributed to the employees, noting that if there were any questions, they could be addressed with Human Resources. Plaintiff Davis apparently did nothing to question the policy. The policy became effective three months later.

Neither party questioned whether the Court should hear the question of unconscionability of the arbitration agreement in the DRP. As the Court noted, relying upon *Nagrampa*, if the complaint is not about the invalidity of the contract as a whole, but only the validity of the arbitration clause, the federal courts are to decide whether the arbitration clause is enforceable.

Turning to procedural unconscionability, the Court found that the DRP was written by a sophisticated employer (that is, a national and international law firm), and that there was no element of “surprise”. In reaching this conclusion, the Court noted that the terms of the policy

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37 Id. at 4.
38 Id.
39 Id.
40 Id. at 9.
41 485 F.3d 1066 (9th Cir. 2007).
42 Id. at 1070.
43 Id. at 1072.
were clearly set out in uppercase text and in bold type. However, the Court found that “in a very real sense the DRP was ‘take it or leave it’”.44

O’Melveny argued that providing three months prior notice addressed the concern of “oppression”, relying upon a “marketplace alternatives” theory used in cases outside the employment context. The Court, however, noted that “even if the opportunity to walk away was ‘meaningful,’ the DRP was still a ‘take it or leave it’ proposition” and that, as in Ingle v. Circuit City Stores, Inc.,45 the amount of time available to consider the contract was irrelevant.46

Citing Nagrampa, the Court embraced Nagrampa’s reiteration of the principle of California law that rejects the argument that the availability of other employment can defeat a claim of procedural unconscionability even when an employee is faced with a “take it or leave it” condition of employment.47 The Court found that when an employee is faced with an employer with “overwhelming bargaining power” that “drafted the contract, and presented it to [Davis] on a take-it-or-leave-it basis,” the clause is procedurally unconscionable.48

The Court then addressed whether the agreement (or specific provisions of it) was substantively unconscionable. Davis first challenged the “Notice Provision”, which allowed the employee one year from the date a claim is known or should have been known to give notice to the employer. Davis argued that the shortened notice provision is substantively unconscionable in that it deprived her of the application of the “continuing violation” theory.49

The Court stated that it has previously held that “forcing employees to comply with a strict one-year limitation period” is oppressive “in a mandatory arbitration context.” In particular, the Court noted that courts are particularly concerned about barring a “continuing violations” theory by employees. Citing the Ingle case, the Court reasoned that a strict one year statute of limitations is substantively unconscionable because it would deprive employees of the benefit of the continuing violation doctrine, and the benefit of the provision flows only to the employer.50 Thus, the Court found that the one-year limitations period is substantively unconscionable when it forces an employee to arbitrate employment-related statutory claims.51

The Court then turned to Davis’ challenge to the confidentiality provision in the DRP, as to which she argued that it was overbroad and therefore substantively unconscionable under Ting v. AT&T52. In Ting, the confidentiality agreement was found to be substantively unconscionable because such confidentiality provisions usually favor companies over individuals.53 Observing that O’Melveny does “have hundreds if not thousands of employees”

44 Id. at 1073.
45 328 F.3d 1165, 1172 (9th Cir. 2003).
46 485 F.3d at 1074.
47 Id. at 1075.
48 Id.
49 Id. at 1076.
50 Id. at 1076-77.
51 Id. at 1077-78.
52 319 F.3d. 1126 (9th Cir. 2003).
53 485 F.3d at 1078.
who could bring similar claims, the Court found that the DRP’s confidentiality clause as written unconscionably favors O’Melveny, because it imposes restrictions that would prevent an employee from contacting other employees to assist in litigating or arbitrating an employee’s case. This inability, the Court said, would “handicap if not stifle” the employees’ ability to investigate and engage in discovery, “placing O’Melveny in a far superior legal posture.”

Next, Davis challenged the DRP’s non-mutual provision exempting O’Melveny from arbitration in matters involving claims for injunctive relief and/or other equitable relief for violations of attorney-client privilege or the work product doctrine or the disclosure of other confidential information. The Court acknowledged the business purposes or public interest needs of such provisions, noting that “California law allows an employer to preserve a judicial remedy for itself if justified based upon a ‘legitimate commercial need’ or ‘business reality.’” However, citing Nagrampa, the Court stated that “to constitute a reasonable business justification, the justification must be something other than the employer’s desire to maximize its advantage based upon the perceived superiority of the judicial forum.” The Court reasoned that, as Nagrampa explained, “California courts routinely have rejected [protecting proprietary information] as a legitimate basis for allowing only one party to an agreement access to the courts for provisional relief.”

The Court found that even accepting O’Melveny’s justifications, the DRP was still overbroad in that its plain language would allow O’Melveny to go to court to obtain any “equitable relief” for the disclosure of any “confidential information.” The Court concluded that the non-mutual exception as written is “one-sided and thus substantively unconscionable.”

After finding several provisions of the DRP void, the Court addressed the issue of severability. The Court stated that even though the arbitration agreement contains these flawed provisions, it does not necessarily mean that the entire DRP is substantively unconscionable. The question, the Court said, is whether the clause or clauses are “collateral” to the main agreement or whether the DRP is “permeated” by unconscionability.

The Court concluded that the provisions that were unenforceable could not be severed without “gutting the agreement” and that “a court cannot rewrite the arbitration provision for the parties.” Thus, the Court voided the entire DRP.


In Santana Row Hotel Partners, LP v. Zurich American Insurance Company, et al., Santana Row Hotel Partners, LP filed suit against Zurich American Insurance Company

54 Id. at 1078.
55 Id. at 1079-80.
56 Id. at 1080.
57 Id. at 1081.
58 Id.
59 Id. at 1084.
60 Id. at 1084.
61 Id.

Zurich contended that “the Arbitration Agreement was the product of fraudulent inducement on the part of Gallagher, and is therefore unenforceable.” The Court was faced with the issue of whether the fraudulent inducement claim should be decided by the arbitrator or the Court.

The Court noted that “[t]he Supreme Court has distinguished claims that an entire contract was fraudulently induced from claims that the arbitration provision in an otherwise valid contract was fraudulently induced.” The Court also observed that a “district court faced with a fraudulent inducement claim that runs to the entire contract must refer that claim to the arbitrator.” However, when the district court is “faced with a claim that only the arbitration provision was fraudulently induced[,] it must consider such a claim before compelling arbitration.”

The Court pointed out that the Supreme Court cases dealing with whether the court or arbitrator decides the enforceability of an arbitration clause -- Buckeye Check Cashing, Inc. v. Cardegna, and Prima Paint Corp. v. Flood & Conklin Mfg. Co. -- each dealt with an arbitration clause in a broader contract. In this case, the entire contract consisted of the arbitration agreement. “It contain[ed] no broader contractual duties other than to arbitrate covered disputes in the agreed-upon manner.” Therefore, the Court concluded that the issue must be considered by the Court.


*Renee Geoffroy, et al. v. Washington Mutual Bank* came before the court on defendant bank’s motion to compel arbitration of the claims and stay the action based upon an arbitration clause in its checking account signature card. Plaintiff bank customers opposed the motion arguing that the arbitration clause was unconscionable.

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62 No. 05-00198, 2007 U.S. Dist. LEXIS 24866 (N.D. Cal. 2007).
63 *Id.* at 2.
64 *Id.*
65 *Id.* at 6.
66 *Id.*
67 *Id.* at 6.
70 2007 U.S. Dist. LEXIS 24866 at 6.
71 The Court did not reach the issue of whether the arbitration clause was enforceable because it dismissed (without prejudice) the claims as to which arbitration was sought. *Id.* at 7.
72 No. 06-1732, 2007 U.S. Dist. LEXIS 33489 (S.D. Cal. 2007).
Because the plaintiffs did not attack the contract as a whole, but only the arbitration clause, the Court, as in *Nagrampa*, found that it was an issue for the court to decide, applying California law.\(^{73}\)

The Court found that the contract in the case was a contract of “adhesion” and was therefore procedurally unconscionable. The Court noted that a contract of adhesion is “a standardized contract, imposed upon the subscribing party without an opportunity to negotiate the terms.”\(^{74}\)

According to the Court, “[B]oth standards for procedural unconscionability are satisfied by a finding that the arbitration provision was presented on a take-it-or-leave-it basis and that it was oppressive due to an inequality of bargaining power that result[ed] in no real negotiation and an absence of meaningful choice.”\(^{75}\) Additionally, the Court found that the plaintiffs were presented with an arbitration provision that, “if they were aware of it at all, [was] on a take-it-or-leave-it basis.”\(^{76}\)

The Court noted that, as in *Nagrampa*, even if the plaintiffs had other choices for banking, “California has squarely rejected the notion that availability in the marketplace of substitute services alone can defeat a claim of procedural unconscionability.”\(^{77}\) Moreover, the Court found that the element of surprise was definitely present. The Court reasoned that the “plaintiffs in this case had difficulty reading even the larger text on the signature card, much less the very small degraded print concerning the arbitration of claims.”\(^{78}\) Additionally, the Court stated, even if the plaintiffs had taken the opportunity to seek advice on the terms, the contract was still an ambiguous adhesion contract form because the “salient arbitration provision is ambiguous on its face as it uses the phrase, ‘most disputes… are subject to mandatory binding arbitration,’ without specifying which are and which are not.”\(^{79}\) The Court concluded that the “net result is that the element of surprise is great.”\(^{80}\)

Finding that the agreement was oppressive and the element of surprise was “great,” the Court concluded that the procedural unconscionability element was significant. Under California law, where the degree of procedural unconscionability is significant, the level of substantive unconscionability does not need to be great to render an arbitration provision unenforceable.\(^{81}\)

The Court found three instances in this case where substantive unconscionability was present: (1) the cost-splitting provision; (2) the unilateral termination/modify provision; and (3) the lack of mutuality.\(^{82}\)

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\(^{73}\) *Id.* at 3-4.

\(^{74}\) *Id.* at 11, quoting *Nagrampa*, 469 F.3d at 1281.

\(^{75}\) *Id.*

\(^{76}\) *Id.* at 12.

\(^{77}\) *Id.*

\(^{78}\) *Id.* at 14.

\(^{79}\) *Id.*

\(^{80}\) *Id.* at 15.

\(^{81}\) *Id.* at 16, citing *Nagrampa* v. *MailCoups*, 469 F.3d at 1280.

\(^{82}\) *Id.* at 16-17.
The arbitration clause provided that the costs of the arbitration would be shared equally unless the arbitrator allocated them differently. The Court found this cost-splitting provision to be substantively unconscionable because it forces a retail customer to pay for vindicating federal statutory rights and because it permits even a successful claimant to be charged with her share of the arbitration costs.

The Court also found that the arbitration provision was substantively unconscionable because it permits the defendant bank to change unilaterally and without notice the provisions of the contract. The Court stated that by granting the bank itself sole authority to change the arbitration provision without notice, “compounded by the fact that this contract is adhesive in the first instance,” the arbitration provision is further rendered substantively unconscionable. 83

Finally, the Court found that the arbitration provision lacked mutuality. The arbitration agreement reserved to the defendant bank the right to offset its own claims against the account holder, or to exercise a security interest in the property of its account holder, without resorting to arbitration. The Court stated that under California law, “substantive[ ] unconscionability may manifest itself in the form of an agreement requiring arbitration only for the claims of the weaker party but a choice of forums for the claims of the stronger party.” 84 The Court concluded that the lack of mutuality in the case also rendered the arbitration provision substantively unconscionable. 85

5. **Lesa Meyers, et al. v. Conehead Investments, Inc.**

*Lesa Meyers, et al. v. Conehead Investments, Inc., et al.*, 86 came before the Superior Court of the State of California upon the Petition to Compel Arbitration by defendants Cold Stone Creamery, Inc., Douglas A. Ducey, Jim Flaum, David Andow, Donald Sutherland, and Cold Stone Creamery Leasing, Inc. (collectively, “the Cold Stone Defendants”) and the Petition to Compel Arbitration by defendants Conehead Investments, Inc., George B. B. Huggins and Gregory C. Ferrell (collectively, “the Conehead Defendants”). The plaintiffs had entered into a Franchise Agreement and a Transfer Agreement that contained arbitration provisions. The plaintiffs challenged the enforceability of the arbitration provisions on grounds that they were unconscionable. The Court first concluded that the question of whether the parties are bound by the arbitration clause is a question of arbitrability for the court to decide, not an arbitrator. 87

The Court noted that procedural unconscionability concerns the manner in which the contract was negotiated and the circumstances of the parties at the time, pointing out that this may be demonstrated by either “oppression” or “surprise.” The Court concluded that the plaintiffs had shown both “oppression” and “surprise”.

The Court stated that the plaintiffs in both instances suffered “oppression” in the absence of real negotiation or meaningful choice. The Court observed that defendant Cold Stone Creamery, Inc. had superior bargaining strength, and the plaintiffs were presented with a

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83 *Id.* at 18.
84 *Id.* at 18, quoting *Nagrampa v. MailCoups*, 469 F.3d at 1285-68.
85 *Id.*
86 No. BC358836 (Sup. Ct. Cal., April 18, 2007).
87 *Id.* at 1.
“take it or leave it” circumstance by the Conehead Defendants. Thus, the Court concluded that procedural unconscionability was present.

Additionally, the Court noted that, with respect to the Franchise Agreement, plaintiff Meyers “did not reasonably expect that the arbitration provision therein [would] amount to a unilateral agreement to arbitrate on her part.” The Court also found procedural unconscionability in the fact that in the Transfer Agreement, the arbitration provision was hidden in the “Miscellaneous” section.\(^{88}\)

The Court found that the level of substantive unconscionability of the arbitration provision in the Franchise Agreement was significant. In this regard, the Court noted that, among other unconscionable terms, the agreement completely lacked mutuality, limited the damages afforded by the CFIL and created a barrier precluding plaintiff Meyers from vindicating her statutory rights under the CFIL.\(^{89}\)

The Court also concluded that the arbitration provision was “unjustifiably one-sided,” in that it allowed defendants and not plaintiffs to seek provisional and injunctive relief. The Court also pointed out that the arbitration provision allowed defendants to seek remedies at law by merely “asserting a claim which implicates [Cold Stone Creamery] service marks or proprietary information, or relates to confidentiality, restrictions on hiring, or covenants not to compete.” The Court concluded that this was “tantamount” to a unilateral agreement to arbitrate on the part of the plaintiffs, which, citing \textit{Nagrampa}, the Court held was unconscionable.\(^{90}\)

The Court also found that the limitation on consequential damages amounted to an unconscionable waiver of statutory rights. In addition, the Court found that by requiring plaintiffs to pay an $8,000 filing fee plus a $3,250 case service fee and taking the risk that if they were not the prevailing party they would have to pay the costs and expenses of the arbitration, the arbitration provision created a barrier that effectively precluded franchisees like plaintiff Meyers from vindicating their statutory rights under the CFIL.\(^{91}\)

Denying the defendants’ Petition to Enforce Arbitrations, the Court thus concluded that the multiple substantively unconscionable terms, along with the lesser degree of procedural unconscionability it found, were sufficient to refuse to enforce the arbitration clause.\(^{92}\)

\section*{IV. EFFECT OF \textit{NAGRAMPA} IN OTHER STATES}

The Court of Appeals for the Ninth Circuit applied California law in rendering the \textit{Nagrampa} decision. Indeed, throughout its opinion, the Court repeatedly noted that in assessing whether the arbitration clause was unconscionable, it relied upon “California legal principles”.\(^{93}\) The decision is therefore binding on all the federal district courts in the Ninth Circuit that are faced with this issue under California law. While not technically binding on the

\(^{88}\) \textit{Id.} at 2.

\(^{89}\) \textit{Id.}

\(^{90}\) \textit{Id.} at 3.

\(^{91}\) \textit{Id.}

\(^{92}\) \textit{Id.} at 4.

\(^{93}\) \textit{Nagrampa}, 469 F.3d at 1264.
California state courts, because it cites numerous California cases, it is likely California courts will follow the reasoning and holding of the Nagrampa case.

Whether courts applying the law of other states will be persuaded by the Nagrampa decision and reach similar conclusions remains to be seen. Two points of view exist. Mr. Heller believes that other states will not adopt the Nagrampa approach. First, California has often been viewed as doing things differently from the rest of the country. Second, to apply Nagrampa rigidly would probably result in most arbitration clauses in franchise agreements being held unconscionable because they tend to (and Mr. Heller believes appropriately so) carve out of the arbitration clause the franchisor's right to seek injunctive relief to protect important aspects of the system (e.g., the trademarks, trade secrets, etc.) and contain a clause setting the arbitration in the franchisor's home state. Third, there was a substantial dissent by several of the justices in Nagrampa. Moreover, the validity of the decision is questionable based on its own facts: Although the Court described Nagrampa as in a "substantially weaker bargaining position than MailCoups" because she was a first-time franchisee and lacked special training in the field, in fact, she was a sales manager for a company that competed with MailCoups and earned over $100,000 a year. It is noteworthy that as of the date this paper is being prepared – more than 6 months after Nagrampa was issued – we have not been able to locate any court in any other state that has issued a reported decision under another state's law citing to the case and adopting its approach.

On the other hand, Mr. Lagarias believes that the application of basic unconscionability principles, endemic to virtually all states, will likely result in contests to arbitration clauses in franchise agreements. Section 2 of the Federal Arbitration Act ("FAA") expressly provides that arbitration clauses need not be enforced based on the grounds that exist for revocation of contracts in general, such as unconscionability. Many states follow the weighing of procedural and substantive unconscionability, albeit not necessarily in arbitration clause litigation, as utilized by California courts. The second rationale of Nagrampa involves whether an arbitration clause may be unenforceable as against public policy. While this is a developing application, other courts are addressing such claims to contest arbitration clauses and can be expected to do so in the future.

V. THE FRANCHISOR VIEWPOINT: DRAFTING AROUND THE NAGRampa RULING -- SUGGESTIONS AND A SAMPLE

Franchisors with a significant number of franchisees based in California will most likely redraft any arbitration clauses in their agreements to seek to avoid the bases upon which the Nagrampa Court voided the clause there. As noted above, the Nagrampa Court found to be unconscionable (or at least seriously questioned) the following aspects of the arbitration clause in that case: (1) lack of mutuality; (2) the forum selection part of the clause; and (3) fee-splitting.

94 An analysis of the contractual doctrine of unconscionability is beyond the scope of this paper, but numerous states have used unconscionability, and often weighed procedural and substantive unconscionability, to bar enforcement of arbitration clauses. E.g., Wisconsin Auto Title Loans, Inc. v. Jones, 290 Wis. 2d 514, 714 N.W.2d 155, 164-169 (2006) (arbitration clause unenforceable based on procedural and substantive unconscionability); Ski River Dev., Inc. v. McCalla, 167 S.W.3d 121, 136-139 (Tex. App. 2005) (lease held unconscionable and unenforceable following procedural and substantive unconscionability analysis); Eagle v. Fred Martin Motor Co., 157 Ohio App. 2d 150, 166, 809 N.E.2d 1161, 1173 (2004) (granting of motion to compel arbitration reversed because arbitration clause was procedurally and substantively unconscionable); Plaskett v. Bechtel Intern., Inc., 243 F. Supp. 2d 334, 339-40 (D.V.I. 2003) (arbitration provisions in employment contract held unconscionable); Bellevue Drug Co. v. Advance PCS, 333 F. Supp. 2d 318, 332 (E.D. Pa. 2004) (arbitration cost shifting provisions enforced as plaintiffs provided no competent evidence of adhesion contracts).
There are several ways to modify the typical arbitration clause in a franchise agreement to try to deal with these three issues. Following are a few suggestions.

As to the lack of mutuality, franchisors should consider making the various provisions in the arbitration clause reciprocal and applicable to both the franchisee and the franchisor. The particular asymmetry the Nagrampa Court seized upon was the fact that the franchisor reserved the right to file in court for provisional injunctive relief to protect its trademarks and proprietary information, while the franchisee was required to arbitrate all of its claims. Though Mr. Heller believes that such an exception to the requirement of arbitration is an appropriate one, after the Nagrampa decision, franchisors would be well-advised to draft the clause to give both the franchisee and the franchisor the right to proceed in court to obtain provisional relief. The result would be a clause that reserves for the franchisor the right to sue in court to enjoin preliminarily a franchisee from misusing a trademark or disclosing confidential information, but would also allow the franchisee to sue in court to seek to enjoin on a preliminary basis, for example, a termination by the franchisor, the implementation of some new policy by the franchisor or a decision by the franchisor that will allegedly irreparably harm the franchisee.

Along similar lines, franchisors concerned about the Nagrampa decision may want to make sure that the provisions in the arbitration clause (including those relating to the remedies available) are not one-sided. Thus, if the franchisee waives the right to recover punitive damages, the franchisor should also waive that right. Similarly, to comply with Nagrampa, attorneys’ fees provisions should apply to the franchisee and the franchisor, as should the contractual limitations provisions (e.g., requiring that any action be brought within a certain time after the events giving rise to the claim).

The Nagrampa Court’s finding of unconscionability regarding the forum selection clause (requiring a California-based franchisee to arbitrate in Boston) is a more difficult problem to address without sacrificing the benefits to a franchisor of having arbitrations in its home state. The franchisor could, of course, either not include a forum selection clause at all or designate the forum where the franchisee is based. However, neither of those alternatives protects the franchisor from being required to respond, at the same time, to several arbitrations in multiple distant states, wrecking havoc with management’s time and complicating the franchisor’s efforts to defend itself.

One suggestion is to draft the franchise agreement to provide the franchisor’s home state as the forum for any arbitration in exchange for the franchisee paying a reduced initial franchise fee. In this way, it will be clear that the presence of the forum selection clause was brought to the attention of the franchisee (as he or she will need to initial whether it will accept the forum of the franchisor for the lesser initial fee) and, more importantly, that there was a quid pro quo for the forum selected. Because the franchisee could avoid the franchisor’s home state as the forum by foregoing the reduction in the initial fee, this method should help overcome the “procedural unconscionability” objection, because the forum selection will not be on a “take-it-or-leave-it” basis, the franchisee will not be “surprised” by it and it will not be “oppressive” because he or she could have avoided the franchisor’s home state as the forum yet still become a franchisee.

As to the “fee-splitting” provision, the franchisor could draft the arbitration clause to allow it (the franchisor) to pay for all the costs of the arbitration should the provision be found to be unconscionable. This might be particularly important in situations involving statutory claims.
being brought by the franchisee. In the IAMCO case,\textsuperscript{95} the Court emphasized the need to preserve a franchisee’s right to file an unwaivable statutory claim, unimpeded by the requirement to pay the costs of the arbitration.

Here is a sample arbitration clause that incorporates these suggestions, as well as others:

I. **COSTS AND ATTORNEYS’ FEES**

If either we or you seek to enforce this Agreement in an arbitration, judicial or other proceeding, the prevailing party shall be entitled to recover its reasonable costs and expenses (including attorneys' fees, arbitrators' fees and expert witness fees, costs of investigation and proof of facts, court costs, other arbitration or litigation expenses and travel and living expenses) incurred in connection with the claims on which it prevailed.

II. **ARBITRATION**

All controversies, disputes or claims between us [and our affiliates and our and their respective owners, officers, directors, agents and employees, as applicable] and you [and your affiliates and your and their respective owners, officers, and directors, as applicable] arising out of or related to:

(1) this Agreement or any other agreement between you [or your owners] and us or any provision of any of such agreements;

(2) our relationship with you;

(3) the scope or validity of this Agreement or any other agreement between you [or your owners] and us or any provision of any such agreements (including the validity and scope of the arbitration obligation under this Section, which we and you acknowledge is to be determined by an arbitrator, not a court); or

(4) any System Standard (as defined above)

will be submitted for arbitration to the [name of arbitration provider]. Except as otherwise provided in this Agreement, such arbitration proceedings shall be heard by one arbitrator in accordance with the then-existing Rules of the [name of arbitration provider]. All matters within the scope of the Federal

\textsuperscript{95} 133 Cal. App. 4\textsuperscript{th} 396, 34 Cal. Rptr. 3d 659.
Arbitration Act (9 U.S.C. §§ 1, et seq.) will be governed by it and not by any state arbitration law.

The arbitration proceedings shall be held at a suitable location to be chosen by the arbitrator within the city in which we are based at the time of the commencement of the arbitration. (In exchange for you agreeing to this location for the arbitration proceedings, the franchise fee referenced in Section ___ above is reduced to $______.)

In reaching his or her decision, the arbitrator shall follow the terms of this Agreement, shall be bound to apply the applicable law and shall not rule inconsistently with the applicable law. The arbitrator shall include in his or her award any relief he or she deems proper in the circumstances, including money damages (with interest on unpaid amounts from the date due at the maximum rate allowed by law), specific performance, injunctive and declaratory relief and attorneys’ fees and costs, provided that: (a) the arbitrator shall not have authority to declare any Mark generic or otherwise invalid; and (b) we and you waive to the fullest extent permitted by law any right to or claim for any punitive, exemplary, and treble and other forms of multiple damages against the other. The award of the arbitrator shall be conclusive and binding upon all parties hereto and judgment upon the award may be entered in any court of competent jurisdiction.

[Other than as may be required by law, the entire arbitration proceedings (including, but not limited to, any rulings, decisions or orders of the arbitrator), shall remain confidential and not be disclosed to anyone other than the parties to this Agreement.]

We and you agree to be bound by the provisions of any limitation on the period of time by which claims must be brought under this Agreement or applicable law, whichever expires first. We and you further agree that, in connection with any such arbitration proceeding, each shall submit or file any claim which would constitute a compulsory counterclaim (as defined by the then-current Rule 13 of the Federal Rules of Civil Procedure) within the same proceeding as the claim to which it relates. Any such claim which is not submitted or filed in such proceeding shall be barred. The arbitrator may not consider any settlement discussions or offers that might have been made by either you or us. We reserve the right, but have no obligation, to advance your share of the costs of any arbitration proceeding in order for such arbitration proceeding to take place and by doing so shall not be
deemed to have waived or relinquished our right to seek the recovery of those costs in accordance with Section I. above.

We and you agree that arbitration shall be conducted on an individual, not a class-wide or group, basis, that only we [and our affiliates and our and their respective owners, officers, directors, agents and employees, as applicable] and you [and your affiliates and your and their respective owners, officers and directors, as applicable] may be the parties to any arbitration proceeding described in this Section, and that no such arbitration proceeding shall be consolidated with any other arbitration proceeding involving us and/or any other natural person, association, corporation, partnership, limited liability company or other entity. The parties also agree that in the event of individual arbitrations involving the same or similar issues filed at or about the same time (whether or not originally filed improperly as a class action, group or consolidated arbitration and then separated into individual arbitrations), no arbitrator shall be an arbitrator in more than one of those individual arbitrations. [Notwithstanding the foregoing or anything to the contrary in this Agreement, if any court or arbitrator determines that all or any part of the preceding two sentences is unenforceable with respect to a dispute that otherwise would be subject to arbitration under this Section, then all parties agree that this arbitration clause shall not apply to that dispute and that such dispute shall be resolved in a judicial proceeding.]

The provisions of this Section are intended to benefit and bind certain third party non-signatories and will continue in full force and effect subsequent to and notwithstanding the expiration or termination of this Agreement.

Notwithstanding anything to the contrary contained in this Section, we and you have the right in a proper case to obtain temporary restraining orders and temporary or preliminary injunctive relief from a court of competent jurisdiction. In that case, we and you agree to contemporaneously submit the merits of our dispute to arbitration according to this Section.

VI. THE FRANCHISEE VIEWPOINT: UTILIZING NAGRAMPA AND RELATED PRINCIPLES TO CONTEST OVERREACHING ARBITRATION CLAUSES

From the viewpoint of a franchisee attorney, Nagrampa, and its antecedents, provide ample authority for challenging certain overreaching and unfair arbitration clauses. Franchisee counsel should consider the dispute resolution provisions to determine whether they violate the
rules and principles of Nagrampa. Such violations may provide grounds for challenging the arbitration provisions. As the United States Supreme Court recognizes: “[b]y agreeing to arbitrate a statutory claim, a party does not forgo the substantive rights afforded by the statute; it only submits to their resolution in an arbitral, rather than a judicial, forum.”

It is unlikely that the primary grounds invoked for challenging arbitration clauses in Nagrampa, i.e., unconscionability, will be invalidated in future cases. The FAA specifically provides for enforcement of arbitration agreements except for grounds for revocation of the franchise agreement. The grounds for revocation are state law grounds, such as unconscionability, public policy, or fraud in the inducement of the arbitration clause.

In any challenge to an arbitration clause, the grounds for revocation asserted should address the arbitration clause itself rather than the entire agreement. Thus, fraud in the inducement of the entire contract will not trump enforcement of the included arbitration clause, i.e., the fraud must involve the arbitration clause itself such as a misrepresentation that the arbitration clause would not be enforced. Likewise, an attack on an entire loan agreement as usurious, rather than the included arbitration clause within the loan agreement, will not preclude arbitration as the alleged illegality of the entire loan agreement will be decided by the arbitrator.

Since the methodology of attack rests with the arbitration clause itself, how should franchisee counsel utilize Nagrampa? The answer to this question has both a procedural and a substantive aspect. When there are grounds for contending the arbitration clause is unconscionable, procedurally franchisee counsel should either file a lawsuit first, or, if the franchisor has filed an arbitration demand first, seek judicial relief to stay the arbitration.

The substantive aspect involves an analysis of applicable state law, primarily regarding unconscionability and public policy, to determine whether there are grounds for revocation. As noted above, Mr. Lagarias believes that the Nagrampa standards of unconscionability, i.e., applying the State of California’s case law regarding unconscionability, will be applicable in many if not most jurisdictions. Unconscionability is a legal doctrine applicable in almost all states; unfortunately it is beyond the scope of this paper to review the standards of unconscionability in every state. Moreover, the California sliding scale approach outlined in Nagrampa and IAMCO can be shown within mainstream jurisprudence.

Litigation over the procedural aspect of unconscionability will likely center on oppression because franchisors will contend that there is no surprise when franchisees are provided a UFOC (eventually to be a Franchise Disclosure Document) which discloses mandatory arbitration as well as a copy of the franchise agreement they are to sign with a statutory or regulatory cooling off period. Nagrampa and California decisions consistent with it generally focus on oppression stemming from a “take it or leave it” franchise agreement. In Nagrampa the

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100 133 Cal. App. 4th 396.
Ninth Circuit said: “[w]hether the plaintiff had an opportunity to decline the defendant’s contract and instead enter into a contract with another party that does not include the offending term is not the relevant test for procedural unconscionability.” Mr. Lagarias believes that franchisee counsel involved in arbitration enforcement proceedings should, when applicable, support the showing of a “take it or leave it” approach with a declaration from the franchisee client on this issue.

The substantive aspect of unconscionability involves analyzing what franchisee counsel refer to as the “thumb on the scale” nature of many dispute resolution provisions added to franchise agreements. While there are not yet a plethora of cases on these issues involving franchisees, arbitration clauses found to be substantively unconscionable in employment and consumer agreements provide guidance. Some examples primarily from California are:

A. **Lack of Mutuality in Arbitration**

*Armendariz v. Foundation Health Psychcare Servs.*[^102^] (“We agree with the Stirlen court that the ordinary principles of unconscionability may manifest themselves in forms peculiar to the arbitration context. One such form is an agreement requiring arbitration only for the claims of the weaker party but a choice of forums for the claims of the stronger party.”).

*Wisconsin Auto Title Loans, Inc. v. Jones*[^103^] (arbitration clause in loan contract found unenforceable based on unconscionability, resulting from lack of mutuality).

*Padilla v. State Farm Mut. Auto Ins.*[^104^] (“Escape hatch” allowing trial de novo of awards in excess of limits was unconscionable, but was severed allowing enforcement of arbitration provision).

*Lloyd v. Hovensa, LLC*[^105^] (confidentiality provisions of AAA arbitration rules were unconscionable in employment arbitration agreement, but arbitration was enforceable following severance of confidentiality provisions).

*Wilcox v. Valero Refining Co.*[^106^] (employer’s post dispute arbitration provisions were unconscionable as against previously filed EEOC discrimination claim of employee).

*In re Currency Conversion Fee Antitrust Litigation*[^107^] (credit card issuer’s post litigation arbitration notice to credit card holders was unconscionable and unenforceable).

*Arnold v. United Companies Lending Corp.*[^108^] (lending agreement arbitration provisions were unconscionable for lack of mutuality).

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[^101^]: Id., 463 F.3d at 1283; accord, *Davis v. O’Melveny & Meyers*, 485 F.3d 1066.
[^102^]: 24 Cal. 4th at 119.
[^103^]: 290 Wis.2d 514, 714 N.W.2d 155, 164-169 (2006).
B. Limiting Damages and Statutory Remedies

*Independent Association of Mail Box Center Owners v. Mail Boxes Etc., USA, Inc.*\(^{109}\) ("An arbitration clause that is so one-sided as to deprive the weaker party of substantive claims, or the right to punitive damages recovery, is against public policy and unconscionable.").

*Stirten v. Supercuts, Inc.*\(^{110}\) ("In short, the arbitration clause provides employers more rights and greater remedies than would otherwise be available and concomitantly deprives employees of significant rights and remedies they would normally enjoy. Considering the terms of the arbitration clause in the light of the commercial context in which it operates and the legitimate needs of the parties at the time it was entered into, we have little difficulty concluding that its terms are " 'so extreme as to appear unconscionable according to the mores and business practices of the time and place.'....").\(^{111}\)

*Booker v. Robert Half International, Inc.*\(^{112}\) (punitive damages waiver in arbitration clause was unenforceable, but could be severed as employer had not engaged in bad faith drafting).

*Alexander v. Anthony Intl., L.P.*\(^{113}\) (restrictions on remedies, and clause requiring loser to pay arbitration fees and costs were unconscionable).

C. Shortened Statutes of Limitations

*Martinez v. Master Protection Corp.*\(^{114}\) ("If there was any doubt, after Armendariz, it is clear that 'parties agreeing to arbitrate statutory claims must be deemed to 'consent to abide by the substantive and remedial provisions of the statute... Otherwise, a party would not be able to fully' 'vindicate [his or her] statutory cause of action in the arbitral forum.' "' "'(Armendariz, supra, 24 Cal. 4th at p. 101; citation omitted.) The shortened limitations period provided by FireMaster's arbitration agreement is unconscionable and insufficient to protect its employees' right to vindicate their statutory rights.").

*Vlahos v. International Baking Company, Inc.*\(^{115}\) (shortening of statutes of limitations in distributorship agreement was unconscionable).

*Davis v. O'Melveny & Meyers*\(^{116}\) (as discussed above, shortening of statutes of limitations was unconscionable).

*Parilla v. IAP Worldwide Services VI, Inc.*\(^{117}\) (thirty day notice period and clause requiring each side to bear its own attorney’s fees and costs were unconscionable but court


\(^{111}\) Id. at 1542.


\(^{113}\) 341 F.3d 256, 264-65 (3d Cir. 2003).


\(^{116}\) 485 F.3d. 1066 (9th Cir. 2007).

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remanded regarding severance of unconscionable terms and whether clause requiring loser to pay arbitral costs was unconscionable).

Alexander v. Anthony Intl., L.P.\textsuperscript{118} (thirty day notice provision was unconscionable).

D. Forum Selection and Choice of Law in Tandem or Separately

American Online v. Superior Court\textsuperscript{119} (“Wimsatt was an action by weight-loss center franchisees against their franchisor under California's Franchise Investment Law (FIL) (Corp. Code, § 31000 et seq.). The franchisees signed franchise agreements which, \textit{inter alia}, required them to sue in Virginia, the home state of the franchisor. (Wimsatt, supra, 32 Cal. App. 4th at p. 1513-1514.) ...Under those circumstances, enforcing the forum selection clause would effectively waive the remedies of California's FIL, thereby violating the antiwaiver component of that law. ... California courts will refuse to defer to the selected forum if to do so would substantially diminish the rights of California residents in a way that violates our state's public policy.”\textsuperscript{120}).

Hall v. Superior Court\textsuperscript{121} (choice of law and choice of forum provisions unenforceable regarding California securities law claims).

Nagrampa v. Mailcoups, Inc.\textsuperscript{122} (“[U]nder California law, the burden of proving not only the reasonableness and fairness of the arbitration provision, but also that the CLRA's anti-waiver provision is not violated, rests with MailCoups. \textit{Wimsatt}, 32 Cal. App. 4th at 1522, 38 Cal. Rptr. 2d 612. MailCoups has not met this burden.”\textsuperscript{123}).

Aral v. Earthlink, Inc.\textsuperscript{124} (consumer class action waiver and out of state forum provisions held unenforceable).

Bolter v. Superior Court\textsuperscript{125} (“Under the circumstances, the 'place and manner' terms are unduly oppressive. The agreement requires franchisees wishing to resolve any dispute to close down their shops, pay for airfare and accommodations in Utah, and absorb the increased costs associated in having counsel familiar with Utah law. To rub salt in the wound, the agreement provides franchisees are precluded from consolidating arbitrations to share these increased costs among themselves. And the potential to recoup expenses with a favorable verdict is limited by the restriction against exemplary or punitive damages.”\textsuperscript{126}).

\textsuperscript{117} 368 F.3d 269, 276-277 (3d Cir. 2004).
\textsuperscript{118} 341 F.3d 256, 264-65 (3rd Cir. 2003).
\textsuperscript{120} \textit{Id.}, 90 Cal. App. 4th at 10, 12.
\textsuperscript{121} 150 Cal. App. 3d 411, 197 Cal. Rptr. 757 (1983).
\textsuperscript{122} 469 F.3d 1257.
\textsuperscript{123} \textit{Id.} at 1289.
\textsuperscript{125} 87 Cal. App. 4th 900 (2001).
\textsuperscript{126} \textit{Id.} at 909.
E. Public Policy Statutes and Arbitration Under Armendariz

An alternate ground restricting enforcement of arbitration agreements is to provide for vindication of statutes enacted for a public purpose.\textsuperscript{127} The reason for such a result was underscored by the United States Supreme Court that in agreeing to arbitrate statutory claims a party does not agree to limit the substantive rights under those statutes.\textsuperscript{128} \textit{Nagrampa} recognized these principles: "Second, California courts refuse to enforce arbitration provisions on public policy grounds if they impede the enforcement of unwaivable statutory rights."\textsuperscript{129}

In \textit{Armendariz}, the California Supreme Court held that five minimum requirements were necessary for lawful arbitration of statutory claims involving public policies:

"(1) provides for neutral arbitrators;

(2) provides for more than minimal discovery;

(3) requires a written award;

(4) provides for all of the types of relief that would otherwise be available in court, and

(5) does not require employees to pay either unreasonable costs or any arbitrators' fees or expenses as a condition of access to the arbitration forum."\textsuperscript{130}

In \textit{IAMCO},\textsuperscript{131} the Court of Appeal expressed the view that the \textit{Armendariz} public policy arbitration limitations applied to several statutory claims filed by a franchisee. The franchisee claims involved alleged violations of the CFIL, the Cartwright Act, violations of the Uniform Trade Secrets Act, and violations of Section 17200 of the California Business & Professions Code. In \textit{IAMCO}, the Court of Appeal held:

However, franchisees are also asserting that MBE violated numerous statutory provisions, including the Franchise Investment Law (Corp. Code § 31000 et seq.), the Uniform Trade Secrets Act (Civ. Code § 3426 et seq.) and the Unfair Competition Law (Bus. & Prof. Code § 17200 et seq.) . . . These statutory claims affect the public interest and appear to fall all or in part within the \textit{Armendariz}, \textit{supra}, 24 Cal. 4\textsuperscript{th} 85, 19 Cal. Rptr. 2d 745, 6 P.3d 669 and \textit{Boghos, supra}, 36 Cal. 4\textsuperscript{th} 495, 30 Cal. Rptr. 3d 787, 115 P.3d 68.\textsuperscript{132}

\textsuperscript{127} \textit{Armendariz v. Foundation Health Psychare Services}, 24 Cal. 4\textsuperscript{th} 53; \textit{Cole v. Burns Intern. Security Services}, 105 F.3d 1465 (D.C. Cir. 1997).

\textsuperscript{128} \textit{Mitsubishi Motors v. Soler Chrysler – Plymouth}, 473 U.S. 614, 628, 105 S. Ct. 3346, 3354, 87 L. Ed. 2d 444 (1985), quoted in \textit{Armendariz}, 24 Cal. 4\textsuperscript{th} at 98-99.

\textsuperscript{129} \textit{Nagrampa}, 469 F.3d at 1492.

\textsuperscript{130} \textit{Armendariz}, 24 Cal. 4\textsuperscript{th} at 102, citing \textit{Cole v. Burns Intern. Security Services}, 105 F.3d 1465, at 1482 (D.C. Cir 1997).

\textsuperscript{131} 133 Cal. App. 4\textsuperscript{th} 396.

\textsuperscript{132} \textit{id.} at 416.
Accordingly, the plaintiff franchisees in IAMCO would not have to pay arbitration fees regarding their statutory clauses.\footnote{Id. at 416-417.} Nagrampa recognized this ruling, noting that “[t]he California Court of Appeal has previously found that vindication of statutory rights under the FIL, the UCL, and the CLRA deserves protection from insurmountable and unreasonable arbitration fees.”\footnote{Nagrampa, 469 F.3d at 1292.}

**VII. ADR METHODS -- ADVANTAGES AND DRAWBACKS IN THE FRANCHISE CONTEXT**

With the ever-increasing resistance to enforcing arbitration clauses by the courts, franchisors and franchisees should step back from the methods they may have used in the past and consider whether that method should continue to be the way their disputes should be addressed going forward. The remainder of this paper will therefore review the basic differences between mediation, arbitration and litigation as they may be particularly relevant to a franchise dispute.\footnote{The sections that follow were written by Mr. Heller and originally published as part of the “ICFE Study Guide for Franchise Executives” published by the International Franchise Association.}

**A. Mediation**

While not an alternative to arbitration, mediation has become ever more popular with franchisors. Mediation is the negotiation of a dispute between the parties involved that is conducted with the assistance of a neutral third party who is usually selected by the parties. The mediator – unlike a judge, jury or arbitrator – does not render a decision or adjudicate any issues. Rather, the mediator functions as a middle-person with the goal of bringing the parties to a mutually acceptable resolution of the dispute. Mediation is usually conducted in an informal, flexible manner in which there are no rules of evidence or of procedures. It is the informality and lack of evidentiary and procedural rules that makes mediation a very cost-effective and expedient method of resolving disagreements.

Mediation may result from a contractual provision entered into between the franchisor and franchisee at the initiation of the relationship or an agreement between the parties that is voluntarily entered after the dispute arises. While mediation resulting from either of these sources may be productive and save the parties expense and time, mediation works best when the parties are committed to trying to achieve an amicable solution to the problem they face.

In the past, it was often thought that the party that first suggested negotiation or mediation reflected a lack of confidence in its position. The increased use of mediation – and its acceptance as a recognized method of avoiding the slow and expensive process of litigation or arbitration – has removed any such concerns. Moreover, any such concerns can be eliminated by a mediation provision in the franchise agreement even before any dispute arises.

The process is by no means uniform from one mediation to another. Typically, after a mediator is selected, the parties submit statements of their position, or present their position orally, to the mediator (and/or the other side). The mediator then conducts a series of negotiating sessions – sometimes with both parties present and at other times with only one of
the parties present. The mediator seeks to understand the various interests involved in the dispute and attempts to point out to each side the weaknesses and risks in their respective positions. Although the mediator cannot impose any settlement upon the parties, the mediator can certainly recommend settlement approaches to each side.

One particular benefit of the mediation process is that it can remain confidential. The parties usually by agreement provide that the mediation process will be confidential and that nothing said in the mediation will be admissible as evidence in any subsequent arbitration or litigation. The parties will also frequently agree that either side may impart information to the mediator, directing the mediator not to disclose that information to the other side. The obvious benefit of this approach is that the mediator can often make suggestions and propose alternate solutions to resolve a dispute which could not as easily be obtained if the negotiation were directly between the parties.

If mediation is successful, the solution agreed upon is embodied in a written agreement signed by both parties. This agreement becomes an enforceable contract and may well contain an adjudicative method (such as further mediation, arbitration or litigation) to resolve any disputes that may arise under the agreement. It is important that the written agreement be prepared as soon as possible after a resolution of the dispute.

Even when the dispute cannot be settled through mediation, the process has the potential benefit of isolating and identifying the specific areas in dispute, while clarifying those issues as to which there may be agreement. The benefit of this approach is that if arbitration or litigation is commenced after a mediation has been held, that arbitration or litigation may be more narrowly circumscribed, thus decreasing the resources, expense and time otherwise required to resolve the entire matter. On the other hand, when a mediation is unsuccessful, a party may run the risk of having disclosed certain of its legal theories and facts, while strategically it may have been advisable to have locked the other party into its version of the facts first.

The major difference between mediation and arbitration/litigation is the greater speed and lower cost involved in mediation. Mediations are usually conducted in a one or two-day period. While preparation for the mediation is necessary, it pales in comparison to the preparation of a case for an arbitration hearing or trial. None of the expensive depositions and document production, and none of the procedural battling, that occurs in litigation occurs in mediation.

Unlike arbitration and litigation, there is no “win” in mediation but only a negotiated settlement that reflects a compromise between the respective positions of the parties. Mediation affords each side the opportunity to voice its position and, in a sense, vent its anger and emotions. The benefit of allowing the parties to do so in the mediation context, as opposed to the arbitration or litigation context, is that the risks the parties assume by allowing their emotions to become more pronounced are lower. In many franchise disputes, the franchisee seeks the arbitration or litigation to “have his day in court.” The mediation process allows that franchisee to express his or her strongly-held beliefs and contentions to a neutral third party, and, more importantly, to a representative of the franchisor, without the risk that emotions are going to prejudice his or her case.

Many of the disputes that arise in a franchise relationship relate to the variant interests franchisors/franchisees have, and do not necessarily relate directly to matters addressed in the franchise agreement. Therefore, mediation often provides a means of resolving disputes by
taking into account the competing interests of the parties and achieving a result that could not have been imposed by a court or arbitrator. Adjudication of rights (whether by arbitration or litigation) tends to result in the adoption of the views of one party (at least on a particular issue) and does not lend itself to a resolution that falls somewhere between the respective positions being advocated by both parties. Mediation offers a unique benefit in the franchise context particularly when the parties have a sincere interest in obtaining a resolution that will enable them to continue their relationship beyond the dispute then at issue.

Mediation is a creature of contract and, therefore, the rules and principles to be followed in the mediation process (including such matters as selection of the mediator, the procedure to be followed, the degree of confidentiality to be imposed, the precise manner in which the mediation session is to be conducted, etc.) can all be altered by the parties themselves. While this feature is applicable to arbitration as well as mediation, litigation, in contrast, has its own set of rules and requirements.

This flexibility allows the parties the freedom to specify whether the mediator will have any particular expertise or prior experience that may be considered relevant to a better understanding of the dispute, thus leading to a more insightful resolution. For example, the parties can specify that the mediator be experienced with franchise systems, or with a particular industry in which the franchise system involved operates. Often, the greater the experience and general knowledge of the mediator with respect to the particular type of dispute, the greater is the likelihood that a resolution will be achieved. The creativity of the mediator – whether based upon prior experience with franchise systems or the industry or simply based on experience as a mediator – can assist the parties greatly in reaching a mutually acceptable resolution.

Unlike litigation, mediation does not set any judicial precedent. The parties in mediation are free to reach an agreement that affects only their particular relationship without that agreement setting a precedent as a legal matter for others in the system. However, while in theory this is the case, a franchisor must always be cognizant of the fact that the result of the mediation – and the rights agreed to through the mediation – are very likely to be communicated through the franchisee network. As a result, the franchisor should consider the “practical precedential nature” of its agreement in a particular mediation on the rest of its system.

One of the key differences between mediation and arbitration or litigation is simply the effect of the process. Arbitration and litigation often end up polarizing the parties, while mediation – because of its basic nature and goal – tends to bring the parties closer together—most, but not all the time. Because of the adversarial nature of arbitration and litigation, the parties often become emotionally wedded to their positions and this may itself complicate achieving a settlement. By contrast, the parties in mediation (assuming the mediation occurs before the litigation has begun), while emotionally dedicated to their positions, have not necessarily become emotionally antagonistic toward each other. This may enable the parties in a mediation to achieve a settlement that could not be achieved after even a few months of intense discovery in litigation.

Some believe that all cases should be mediated. While very little is lost by an attempt at mediation even if it is unsuccessful (if one is careful as to what facts and legal theories are disclosed in the mediation), there are certain situations in which it would be extremely difficult to achieve a mediated result. Perhaps the clearest type of dispute in the franchise context that falls into this category is one that involves protection of trademarks and of matters considered proprietary to the system. The franchisor must be very careful not to compromise its ability to protect its trademarks and unique system attributes in any way. As a result, it is often difficult to
achieve a compromise when the use (or perhaps, more appropriately, the misuse) of a trademark or other proprietary designation is involved.

More generally, achieving a settlement through mediation may be difficult when the credibility of a particular party or witness is at issue. While arbitration and litigation are designed (through the processes of discovery and cross examination) to allow the fact-finder to assess credibility and determine the facts, the mediation process does not afford that opportunity. Because there generally is no presentation of witnesses or cross-examination in mediation, it is very difficult to mediate successfully a dispute in which one party swears that these are the facts and the other party swears that they are not.

Although what is said in the mediation will generally, by agreement, be kept confidential, the fact is that the information disclosed to the other side during the mediation will certainly be of some benefit to the opposing party should the matter ultimately end up in arbitration or litigation. For example, information disclosed in the mediation may well prompt the other side to request this information (or related documents) when the matter reaches the arbitration or litigation stage.

The rules of discovery in litigation (and often the more limited discovery allowed in arbitration) may result in all of the information disclosed in the mediation being required to be disclosed in the arbitration or litigation. However, when businesspersons engage in mediation without the assistance of legal counsel, there is the risk that information of a privileged nature may be disclosed in the mediation process that might not be required to be disclosed in an arbitration or litigation. The parties to a mediation should, therefore, take care not to do anything that will result in waiving any attorney-client or other privilege they may have.

In deciding whether to mediate a franchise dispute, perhaps one of the most significant considerations relates to the long-term nature of the franchise relationship. If the dispute involved is one in which neither side seeks to end the relationship, strong consideration should be given to mediation because it is directed toward reaching a mutually agreeable solution that will enable the relationship to continue. In addition, because the mediation process tends not to polarize the parties as frequently as does arbitration and litigation (which may in part be due to the fact that the mediation process is over so quickly), a long-term relationship can more easily survive mediation than it can survive arbitration or litigation.

Need for a judicial precedent may argue against the mediation approach. For example, if the issue involved relates to a system-wide dispute that will arise repeatedly in the future, the franchisor may decide that obtaining a resolution from an arbitrator or a court is necessary and that mediation of a single dispute will not adequately resolve the problem.

Similarly, there may be disputes that can only be resolved when the powers of a court are invoked. If, for example, a franchisee is unwilling to de-identify after the franchise has been terminated, it may be that the coercive powers of a court are necessary so that contempt and other penalties can be imposed for the violation. Mediation simply will not offer the same coercive tool.

What is particularly beneficial to franchisors with respect to mediation is that, unless it is in the context of an existing arbitration or litigation, the settlement reached through the mediation process need not be disclosed in a UFOC. As the new UFOC guidelines go into effect, requiring franchisor-initiated lawsuits to be disclosed, the “non-disclosure benefit” of mediation may prompt even more use of mediation.
B. Arbitration

Contract arbitration clauses of course come in many forms, and have been frequently used in franchise agreements. Some such provisions envision that all disputes arising out of the contract are to be referred to arbitration. Others specify the type of disputes to be so referred, while still others leave it to the mutual agreement of the parties at the time the dispute arises.

Arbitration clauses may spell out the procedural and substantive rules that will govern the arbitration, may default to the rules of the American Arbitration Association or some other provider, or may be silent on these issues. As a general rule and to avoid unpleasant surprises, the drafter of the arbitration clause (generally the franchisor) should attempt to be as specific as possible regarding the types of disputes that are to be arbitrated, and the procedural and substantive rules that are to govern the process.

One general misconception about arbitration is that it permits no discovery. In fact, the amount of discovery is up to the parties, and arbitration clauses run the gamut from little or no discovery to a limited number of depositions, document productions and interrogatories. Even where the parties have not agreed in advance about discovery, the state and federal statutes governing arbitration and the rules of the most prominent providers do permit a limited amount of discovery, particularly in complex cases.\footnote{See, Hart, Ross. “Discovery in Arbitration: A Return to Reason,” 7 California Litigation, Number 3 (Spring 1994), pp. 23-29.}

The parties also generally have the power to dictate the procedures governing the arbitration hearing itself. They can decide if the formal rules of evidence will be used, if witnesses are to be called and how formal the proceeding will be (i.e., how much like a trial it will be). The parties may also choose to have a court reporter present for the hearing, adding to the level of formality, but providing a transcript for possible appeal.\footnote{The courts have made it extremely difficult for the losing party to overturn an arbitration award. Indeed, the California Supreme Court in Moncarsh v. Heily & Blasé, 3 Cal. 4th 1 (1992), upheld an arbitrator’s award despite evidence that the arbitrator had confirmed an illegal fee splitting agreement, stating that “it is the general rule that, with narrow exceptions, an arbitrator’s decision cannot be reviewed for errors of fact or law.” Id. at 11. Similarly, in Yusuf Ahmed Alghanim & Sons v. Toys “R” Us, Inc., 126 F.3d 15 (2d Cir. 1997), the Second Circuit upheld an arbitrator’s award of over $46 million because “[m]ere error in the law or failure on the part of the arbitrator[,] to understand or apply the law is not sufficient to establish manifest disregard of the law,” which was the appropriate standard for reversal of an arbitrator’s award. Id. at 23.}

After the hearing, the arbitrator, like a judge, must render a decision. Unlike a judge, the arbitrator generally must rule within a specified period of time.\footnote{Thirty (30) days for the AAA, unless the parties agree otherwise.} While the ruling itself is generally in writing, many arbitrators do not draft an opinion justifying the result. (The parties can of course agree to require a written opinion from the arbitrator.) Once an award is made, the prevailing party may have it confirmed by a court in order to render the award enforceable.
While decisions like *Nagrampa* may prompt some franchisors to include litigation as the dispute resolution method, franchisors who believe that arbitration is the better method will continue to include arbitration clauses in their agreement. However, if they have a significant number of franchisees in California, they should consider revising their arbitration clauses as suggested above to attempt to deal with the types of problems the *Nagrampa* Court cited in finding the clause in that case to be unenforceable. Conversely, franchisees facing mandatory arbitration who prefer to litigate in court should have their counsel carefully study the arbitration provisions for challenges for unconscionability and public policy grounds.\(^\text{139}\)

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\(^{139}\) As a result of concern regarding mandatory arbitration clauses, recently proposed federal legislation, entitled the Arbitration Fairness Act of 2007, would invalidate pre-dispute mandatory arbitration clauses in consumer, employment, and franchise relationships.
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