Arbitration Decisions in Franchising Cases — They Go Together

By David Gurnick

This month, the Court of Appeal refused to let parties escape written agreements to arbitrate in a distant forum, even though high costs blocked them from participating. *MKJA Inc. v. 123 Fit Franchising LLC* 2011 WL 9727 (C.A. 4th Dist., Jan. 4, 2011). The case involved health club franchisees in California, and their Colorado franchisor. The decision is another in a long series of franchisee-franchisor disputes challenging arbitration and out-of-state venue clauses as unconscionable.

With the nation's largest economy, California is an important market for franchisors nationwide. Thus, many franchise agreements are with California franchisees, and many of these agreements have arbitration clauses. (A 2008 study found about 45 percent of all franchise agreements have such clauses. Drahozal & Wittrock, *"Is There a Flight From Arbitration,"* 37 Hofstra Law Review 71 (2008)). Franchisors usually set venue for arbitration in their home state. With numerous franchise agreements providing out-of-state arbitration, it is no surprise that enforceability of these clauses is frequently litigated in California.

The California franchise-arbitration cases begin with *Southland Corp. v. Keating*, 465 U.S. 1 (1984). Franchisees of 7-Eleven convenience stores claimed their franchisor misled them, violating the Franchise Investment Law (FIL) (Corporations Code Sections 31000 et seq.). The franchisor moved to compel arbitration. The trial court and state Supreme Court ruled that under the FIL, the claims were not arbitrable. The Supreme Court reversed, deciding that the Federal Arbitration Act (FAA), which endorses arbitration, pre-empted the FIL. It rejected the argument that the FAA was a procedural statute for federal courts. The *Southland* decision established the FAA as substantive commercial law, binding in *all* courts, state and federal.

Another California statute, the Franchise Relations Act (FRA), protects franchisees in their ongoing relationships with franchisors. In 1994, the Legislature added a provision that voids any franchise agreement clause setting venue for a dispute outside the state. (Business & Professions Code Section 20040.5). Two cases from the same franchise system considered this statute, with different outcomes.

Franchisees of the Chem-Dry carpet cleaning system sought protection under the FRA from being forced to arbitrate in the franchisor's home state of Utah. Courts agreed with the franchisor that the FAA pre-empted California's prohibition against out-of-state venue clauses. So, in *Bradley v. Harris Research*, 275 F.3d 884 (9th Cir. 2001) the 9th U.S. Circuit Court of Appeals enforced the Utah venue clause. But, in *Bolter v. Superior Court*, 87 C.A.4th 900 (2001) the Court of Appeal favored the franchisee, ruling that arbitration would be in Los Angeles.

Why did the outcomes differ?

In *Bradley*, the franchisee claimed the agreement and its arbitration clause resulted from unequal bargaining power. The court ruled that while *unconscionability* might void an arbitration agreement, *unequal bargaining power* was not sufficient grounds to do so. Therefore, in *Bradley*, there was no basis to void the Utah venue clause.

The franchisee in *Bolter* claimed unconscionability, arguing that the agreement was an adhesion contract, Utah venue was too costly, and arbitrating there would force her to abandon her business. The court saw Florence Bolter as a "mom and pop" franchisee, suffering financial hardship, and unable to leave her business "for any length of time to litigate a dispute several thousand miles away." Agreeing that Utah venue was oppressive, the *Bolter* court relieved the franchisee from being forced to arbitrate out-of-state.

In *Laxmi v. Golf USA* 193 F.3d 1095 (9th Cir. 1999) the 9th Circuit spared a California franchisee from venue in Oklahoma. But the decision was not based on unconscionability. Rather, an offering circular presented before signing the franchisee agreement, said the Oklahoma venue clause might not be enforceable under California law. If the clause was in conflict with the law, the law would control. Due to this language, the 9th Circuit found "there was no meeting of the minds on the forum selection clause," and the franchisee "had no reasonable expectation that it had agreed to a forum other than California."

> Many franchise agreements are with California franchisees, and many of these agreements have arbitration clauses.

Many people fondly remember Mail Boxes Etc. stores, which provided post office box rentals and business services. In 2001, the company was sold to UPS. In a subsequent class action, many franchisees challenged their forced re-branding as UPS stores. The franchisor moved to compel arbitration. Some agreements provided for AAA arbitration. Others used JAMS. The JAMS clauses prohibited class-wide arbitration. Ultimately, the Superior Court granted the franchisor's motion, ordering arbitration.

Various franchisees then filed group arbitration claims, either with AAA or JAMS. When AAA and JAMS refused to administer group arbitrations, the franchisees returned to court, moving to consolidate arbitrations, and claiming the ban on class-wide arbitration was unconscionable in requiring costly duplicative proceedings, which they could not afford. But the trial court denied their motion.

In *Independent Association of Mailbox Center Owners Inc. v. Superior Court*, 133 C.A.4th 396 (2005) the Court of Appeal found the agreements' prohibition of class arbitration was unconscionable. The franchise agreements were standardized contracts, drafted by the party with superior bargaining strength (the franchisor); and franchisees had no choice but to adhere to the contracts or reject them. The court found that common issues of law and fact made group arbitration more economical for dispute resolution. The trial court was directed to strike the clauses banning, and to allow, group or class-wide arbitration.

Additionally, two recent cases examine who decides if an arbitration clause is enforceable. In *Nagrampa v. Mailcoups*, 469 F.3d 1257 (9th Cir. 2006), a California franchisee of a direct mail advertising business claimed venue in Boston was unconscionable due to disparity in bargaining position and financial hardship. The 9th Circuit held that when a complaint challenges the arbitration provision itself, the court decides its validity. But, when a complaint claims the franchise agreement as a whole is invalid, including derivatively its arbitration clause, the arbitrator decides. The 9th Circuit found the arbitration clause unconscionable, and ruled that any arbitration would take place in California.

In *Bridge Fund Capital v. Fastbucks*, 622 F.3d 996 (9th Cir. 2010), franchisees of a payday loan and check cashing business resisted arbitrating in Texas. But unlike in *Nagrampa*, their complaint did not say if they were challenging the agreement as a whole, or just the arbitration clause. The 9th Circuit ruled the court must then look to the motion papers to determine the nature of the objection. The court examined the arbitration clause and found it limited damages available to franchisees, had other non-mutual provisions, conflicted with California public policy protecting franchisee rights, and was therefore unconscionable. The trial court's denial of the franchisor's motion to arbitrate in Texas was upheld.

At the outset of California proceedings in the *MKJA* case, discussed above, the trial court had issued a stay of litigation. That stay was requested under Code of Civil Procedure Section 1281.4 by the franchisor, which had moved successfully in Colorado to compel arbitration. Section 1281.4 requires a California court to stay an action when a motion to compel arbitration is pending or has been granted by another court. Almost two years later, the health club franchisees asked the California court to lift the stay, arguing that arbitration was never initiated because they could not afford the roughly $40,000 per case of filing fees, arbitrator fees and fees for new attorneys in Colorado given their financial losses. The trial court agreed to lift the stay, finding the arbitration clauses unconscionable. But the Court of Appeal reversed, ruling that after the stay was granted, the trial court lacked jurisdiction to lift it merely because a party could not afford the costs of arbitration.

The FAA's endorsement of arbitration pre-empts state laws that limit arbitrability of disputes. But challenges based on unconscionability do not conflict with the FAA. Unconscionability requires proving both procedural unconscionability, such as an adhesion contract, and substantive unconscionability. Such as unfair or oppressive contract terms. California courts, federal and state, often find out-of-state venue to be oppressive and unconscionable, particularly when unaffordable to a small franchisee. But if a party brags or wins a motion to compel arbitration in another state, then the court here lacks power to protect the California franchisee.

David Gurnick is with the Lewitt Hackman firm in Encino. He represents franchisors and franchisees in regulatory compliance, and litigation. He is certified as a specialist in franchising and distribution law by the State Bar Board of Legal Specialization. He can be reached at dgurnick@lewitthackman.com