A Crack In Arbitration Contracts

By David Gurnick and Tal Grinblat

In December, an 11-judge panel of the 9th U.S. Circuit Court of Appeals issued its decision in *Nagrampa v. MailCoups Inc.*, 469 F.3d 1257 (9th Cir. 2006), a case likely to lead to increased challenges to arbitration clauses in franchise agreements and other consumer and commercial contracts.

The court rejected as unconscionable an arbitration clause that set venue for disputes far from Nagrampa's home and business and required the franchisor to arbitrate all disputes, while giving the franchisor the choice whether to arbitrate or seek judicial remedies.

The facts are not unusual for a franchise dispute. Connie Nagrampa was a California franchisee of MailCoups, a Massachusetts-based direct-mail business. After the franchise lost money, Nagrampa terminated the franchise agreement. MailCoups responded by trying to collect unpaid franchise fees in arbitration. The hearing took place in Boston, but Nagrampa did not attend, saying she could not afford the travel. The arbitrator entered a $165,000 award against her.

She went to court in California, claiming the arbitration clause was unconscionable. The U.S. District Court in Northern California found the clause valid and a three-judge panel of the 9th Circuit affirmed. *Nagrampa v. MailCoups*, 401 F.3d 1024 (9th Cir. 2005).

In vacating the decision, the en banc panel first considered whether arbitrators or courts should decide the validity of an arbitration clause. Following *Buckeye Check Cashing Inc. v. Cardegna*, 126 S.Ct. 1204 (2006), the panel held that arbitrators can rule on challenges to an agreement as a whole but that an attack on only the arbitration clause is for the courts to decide. Since Nagrampa challenged only the arbitration clause, the panel proceeded to decide validity.

The court followed California's formula for assessing unconscionability. This requires finding the element of adhesion and proof of both procedural and substantive unconscionability. Adhesion refers to a standardized contract, drafted by the party having superior bargaining strength, and offered on a take-it-or-leave-it basis. *Graham v. Scissor Tail*, 28 Cal.3d 807 (1981). Procedural unconscionability arises from unequal bargaining power, lack of negotiation or surprises hidden in long preprinted contract terms. Substantive unconscionability refers to harsh or one-sided provisions, or lack of mutuality.

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The court analyzed these elements on a sliding scale. Strong evidence of substantive unconscionability can void a provision even if the procedural aspect is weak, which the court said was the situation in this case.

The *Nagrampa* court said "a finding of adhesion is essentially a finding of procedural unconscionability." Because adhesion was a precondition to unconscionability, and only weak evidence of the procedural element is needed, this analytic approach eliminates the element of procedural unconscionability in franchising.

Adhesion characterizes many franchise agreements. Franchisors normally prepare a form of agreement they offer to potential franchisees. In addition, federal and state franchise laws require each franchisor to prepare an extensive disclosure document, called a Uniform Franchise Offering Circular, describing the agreement's terms. (See e.g. FTC Franchise Rule, 16 C.F.R. Sections 436.1 et seq.) In California and some other states, the UFOC must be registered with the state. Thus, varying the terms of a franchise agreement would require amending the UFOC and state franchise registrations, which could be costly. The disincentive to negotiating terms, can result in elements of adhesion in many franchise agreements.

With the elements of adhesion and procedural unconscionability established, the *Nagrampa* court next examined whether the MailCoups/Nagrampa franchise agreement was substantively unconscionable. In two respects the court found the agreement satisfactory. In two other respects the court held the arbitration clause was unconscionable.

Diverging from precedent in the employment context, in particular *Armendariz v. Foundation Psych Healthcare*, 24 Cal.4th 83 (2000), the *Nagrampa* panel held that a provision for splitting attorney fees in the franchise agreement was permissible unless it impeded the franchisee from vindicating statutory requirements. The panel also rejected Nagrampa's assertion that the arbitration clause was unconscionable because the arbitration provider may be biased in favor of MailCoups, a potential source of repeat business. Particularized evidence is needed to establish arbitrator impartiality; the court found that merely raising the claim is insufficient.

But the arbitration clause was held unconscionable because it let MailCoups go to court to seek provisional relief to protect trademarks and trade secrets. Following *Armendariz,* the court found a lack of mutuality in the stronger party, MailCoups, being able to choose litigation for some claims while forcing the franchisee to arbitrate all claims.

More importantly, the agreement was held unconscionable because it required that the arbitration take place in Boston. Considering the parties' respective circumstances, the court found this forum was a severe hardship to Nagrampa, effectively preventing her from making or defending claims. The only reason for the venue was to maximize the franchisor's advantage.

The *Nagrampa* decision will have several significant affects. In franchising, it essentially eliminates procedural unconscionability as a critical element in unconscionability analysis. Franchise agreements, being standard forms, are often adhesion contracts, and the holding that "a finding of a contract of adhesion is essentially a finding of procedural unconscionability" means that many typical retail franchisees, by establishing adhesion, can readily show procedural unconscionability.

Also, because the decision protects a franchisee from a distant venue and condemns clauses that reserve the option to choose the courts only to the franchisor, it will likely encourage franchisee challenges to burdensome arbitration clauses. Many such clauses exist between franchisees and franchisors, so there will be opportunities for unsuccessful franchisees to mount challenges.

The decision should also cause some franchisors to modify their form agreements to be more balanced, at least in areas the court found unconscionable. Perhaps some will abandon arbitration altogether.

In the field of consumer law generally, the decision will lead to a continued expansion of the law of unconscionability, with spillover effects to other contract terms beyond just arbitration. For example, consumer subscription agreements for cellular phone, Internet or cable TV service, and credit card, consumer loan, mortgage, brokerage and bank account agreements often contain terms setting substantial charges in the event of early termination or default, as well as arbitration procedures favorable to the agreement's drafter and comprehensive waivers of liability and damages. Consumers who are unpleasantly surprised by such provisions can be expected to cite the *Nagrampa* decision in their efforts to obtain relief.

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