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Observations on Negotiating Franchise Agreements in Today's Legal Environment

By Rochelle B. Spandorf and Beata Krakus

Franchise law has long characterized franchise agreements as adhesion contracts (*see, Ticknor v. Choice Hotels Int'l,* 265 F.3d 931 (9th Cir. 2001) (Montana law); *Bolter v. Superior Court*, 87 Cal. App. 4th 900 (2001) (California law)). While no empirical data exist on the percentage of franchisors that will negotiate the terms of their franchise contract with prospective franchisees, it is fair to conclude that they remain a minority. To start the pre-sale disclosure process, a franchisor must present a prospect with the terms of its bona fide offer for the sale of a franchise. Frequently, these are the only terms the franchisor is prepared to accept.

Franchisors resist prospective franchisee efforts to negotiate better terms for themselves for any number of reasons. Some franchisors have no incentive to negotiate: Enough prospects are ready to buy a franchise on the franchisor's economic terms. Some franchisors offer their franchises on a strict "take-it-or-leave-it" basis to avoid the administrative burden of managing a network of diverse contracts. Other franchisors eschew negotiating to avoid the possible fallout from charges of favoritism or to simplify the paperwork burdens associated with franchise sales. Some franchisors hide behind the extra disclosure duties that arise from contract negotiations by perpetuating the impression that franchise laws forbid franchisors from negotiating changes to their standard deal, which, of course, is untrue. Franchise laws do not forbid franchisors to negotiate franchise agreements and franchise regulators do not intend for pre-sale disclosure rules to discourage contract negotiations. Nevertheless, the prevailing public perception is that franchise agreements are non-negotiable (*see*, for example, *http://franchises.about.com/od/franchisinglegalissues/f/Fran_negotiate.htm*, as of Dec. 10, 2006).

This is not to say that franchise contracts are never negotiated by franchise parties. In many situations, the franchisee enters the scene with negotiating leverage whether due to a new franchisor's eagerness to close its first few sales or the prospective franchisee's particular experience, relative size, willingness to open up a new market,

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Appeals Court: Courts Decide Enforceability Of Franchise Arbitration Provision

By Robert S. Boulter

The enforceability of franchise arbitration agreements took center stage in the Ninth Circuit Court of Appeals en banc decision in *Nagrampa v. Mailcoups, Inc., American Arbitration Ass'n. (2006)* __ F.3d __, 2006 WL 3478345 ("*Nagrampa II*".) In a 7-4 ruling reversing the decision of the three-judge panel upholding arbitration ("*Nagrampa I*," 401 F.3d 1024), the *Nagrampa II* court struck down the arbitration clause under California principles of unconscionability. Along the way, the court made significant holdings and observations that should garner the attention of franchise practitioners on both sides of the aisle.

The facts and procedure of the case are common in franchise circles. Mailcoups sued its franchisee Connie Nagrampa in arbitration for breach of contract after she failed and terminated the agreement. Although initially filed in Los Angeles, the American Arbitration Association transferred venue to Boston in accordance with the forum selection clause in the agreement. Nagrampa objected to arbitration and brought an action against Mailcoups in California state court alleging fraud and statutory violations as well as

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attacking the arbitration provisions. Mailcoups removed the case to federal court and moved to compel arbitration and to stay or dismiss the case. Nagrampa opposed the motion to compel on state law grounds of unconscionability. The district court found that the arbitration agreement was valid and granted Mail-coups' motion to dismiss. Na-grampa appealed, and the three-judge panel of the court of appeals (*Nagrampa I*), 401 F.3d 1024, affirmed, holding that the unconscionability of an arbitration provision contained in the franchise agreement is a question for the arbitrator to decide. The underpinning of that conclusion was that where an adhesion contract contains an arbitration clause, the arbitrator must decide unconscionability because the issue of adhesion (and thus the procedural prong of unconscionability) pertains to the making of the agreement as a whole and not to the arbitration clause specifically.

The implications of *Nagrampa I* were highly significant to the franchise community. If the decision were upheld, the enforceability of franchise arbitration clauses would almost always begin with the arbitrator — a benefit for the franchisor.

Concerns for franchisees under such circumstances are that an arbitrator would essentially be deciding his or her own jurisdiction, be conflicted with self-interest, and the possible implication of the "repeat player" effect. Moreover, the possibility of piecemeal litigation was raised. If the arbitrator decided that a contract of adhesion existed, then presumably the matter would be returned to the court for a decision on substantive unconscionability and the proper remedy (severance of the offending provisions or denial of arbitration).

Another potentially thorny implication of the *Nagrampa I* decision was that under California law, the enforceability of such arbitration provisions is based on an interdependent sliding scale between procedural and substantive unconscionability. The more one-sided substantive terms are, less evidence of procedural unconscionability is needed and vice versa. Thus, under California law the arbitrator would be required to evaluate substantive unconscionability to determine the issue of procedural unconscionability.

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Reversal in *Nagrampa II*

The *Nagrampa II* court disagreed with the *Nagrampa I* court on the critical issue of who decides the gateway issue of whether a particular arbitration provision is unconscionable. The *Nagrampa II* court dispatched the idea that an arbitrator must decide procedural unconscionability of arbitration agreements embedded in franchise agreements. Instead, under *Buckeye Check Cashing, Inc. v. Cardegna,* __ U.S. __, __, 126 S.Ct. 1204, 1209, 163 L.Ed.2d 1038 (2006), when the crux of a claim is a challenge made to the enforceability of an arbitration clause, as opposed to the contract as a whole, the courts should decide enforceability, rather than the arbitrator deciding. Important to the decision was the fact that Nagrampa's complaint sought no relief attacking the contract as whole. Instead, Nagrampa had pled two causes of action directly challenging the arbitration provisions. A detailed analysis of other circuits' opinions validated the *Nagrampa II* court's conclusion that it was using the proper analysis.

Because of its ruling referring the matter to the arbitrator, the *Nagrampa I* court never reached the issue of substantive unconscionability of Mailcoups' agreement. Similarly, the district court never reached the issue of procedural unconscionability. The *Nagrampa II* court tackled both procedural and substantive unconscionability using California's sliding scale. Nagrampa had three primary substantive complaints about the arbitration agreement: 1) It permitted Mailcoups only to resort to court for provisional and injunctive remedies; 2) It required arbitration in Boston; and 3) It required the parties to share the costs of arbitration.

The *Nagrampa II* court tackled the issue of procedural unconscionability first. Under California law, procedural unconscionability is generally found if a contract is adhesive and oppressive (the concepts tend to overlap). Adhesive agreements are standardized agreements generally presented without a meaningful opportunity to negotiate. Oppression is usually characterized by an inequality in bargaining power and the presentation of a non-negotiable agreement by the dominant party. Mailcoups conceded that the arbitration agreement was non-negotiable and instead argued that no oppression existed because Nagrampa was sophisticated and had other options than entering the agreement. The court disagreed, noting that franchisee sophistication and the existence of other opportunities alone cannot defeat claims of procedural unconscionability. Rather, on the facts here, while Nagrampa made only a minimal showing, it was sufficient enough to reach the question of substantive unconscionability.

The *Nagrampa II* court found portions of Mailcoups' arbitration agreement substantively unconscionable for a lack of mutuality. The provision permitting Mailcoups alone to obtain provisional relief was not justifiable. The court also found the Massachusetts forum unconscionable for two primary reasons. First, Nagrampa had offered sufficient evidence that it would be a hardship for her to litigate in Boston. Second, the offering circular suggested that arbitration would take place in California (a la *Laxmi*), and therefore was misleading. The court went on to discuss that to the extent arbitrating the case in Boston impeded the vindication of statutory claims, the agreement might also be a derogation of California public policy. Significantly, the court noted that the burden of showing that such statutory claims could be properly vindicated in the foreign forum rested with Mailcoups, and that it had not met the burden.

Judge Diarmuid Fionntain O'Scannlain, author of *Nagrampa I,* dissented vigorously on the grounds that *Nagrampa I* was correctly decided in

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the California legislature expects franchisors to register all other negotiated offers before consummating them. It is unclear what additional protections result from requiring franchisors to register a negotiated offer when a franchisee is willing to accept a negotiated deal that, on balance, may be a wash in terms of conferring *additional* benefits. A franchisee who negotiates in California still receives the benefit of the five-business-day re-disclosure rule, which protects the prospect against sharp sales tactics by giving the franchisee extra time to consider whether to accept or reject the negotiated offer. What more protection does registration of the negotiated offer afford? The Department of Corporations does not review the fairness of franchise offers; rather it requires franchisors to disclose that registration does not signify the Department's approval or endorsement of the franchise offer. So, what is accomplished by requiring a franchisor to register the negotiated changes before consummating the deal? Furthermore, who should have standing to complain if the overall negotiated deal does not confer *additional* benefits on a franchise buyer? Just the franchisee who goes ahead and enters into the negotiated sale? What about later franchisees who buy a franchise during the next 12 months? Will the duty to give new prospects who negotiate a copy of past-negotiated terms allow them to complain that a prior sale to someone else did not confer *additional* benefits and should have been registered? None of these issues are addressed in new §31109.1.

With an infinite list of variations that can be made to any franchise agreement, new §31109.1 does little to encourage free negotiation of franchise contracts or dispel misconceptions that franchise agreements are not negotiable. Regrettably, California had the chance to follow the mainstream approach to negotiated sales and leave negotiation as a private affair between contracting parties, but opted not to do so.

California is the only jurisdiction to burden the negotiation process with extra regulations, so it is fair to ask, why is sunny California giving negotiated franchise sales the deep chill? No data show that franchise sales fraud is more prevalent in California than elsewhere in the United States. With laws like §31109.1, the impression that franchise agreements are adhesion contracts may be borne out not just by an unleveled playing field, but also by legislative obstacles to negotiation.

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UFOC from which the actual markup of products could be deduced.

The court also found a genuine issue of material fact as to whether Tubby's must disclose the revenue generated from SDS and the amount of the kickback that Tubby's received from SDS. The court noted that the guidelines for preparation of the UFOC suggest that a franchisor must make such disclosures, and furthermore, that if Tubby's was required to make the disclosures, but failed to do so, a genuine issue exists as to whether the failure to disclose was fraudulent. Thus, the court retained jurisdiction over the franchisees' claims for violations of the MFIL as to Tubby's.

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that a successful challenge of procedural unconscionability on adhesion grounds cannot be made to an embedded arbitration clause unless the arbitration clause itself is targeted as an adhesion contract. Judge O'Scannlain went on to disagree with the majority's holding of substantive unconscionability, opining that the cost of arbitration in Boston was not burdensome and noting that Mailcoups in oral argument had agreed to the application of California law (Nagrampa's statutory claims would be therefore given proper consideration).

And in a separate dissent, Judge Alex Kozinski argued that Nagrampa had waived her right to object to arbitration by her level of participation in arbitration proceedings. While finding Nagrampa's sophistication an important element, Kozinski conceded that if there were a higher degree of substantive unconscionability, in his view the majority's conclusions would have been more palatable. In closing, Judge Kozinski predicted that the Supreme Court might soon weigh in on whether current applications of state unconscionability doctrines are improperly impeding the Federal Arbitration Act. Judge Kozinski is probably correct. Whether *Nagrampa II* will be that case or not remains to be seen.

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