

**American Bar Association  
29th Annual Forum on Franchising**

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**UNCONSCIONABILITY AND FRANCHISE LITIGATION**

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October 11 – 13, 2006  
The Westin Copley Place  
Boston, MA

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## I. INTRODUCTION<sup>1</sup>

Ingrained in our legal system is “freedom of contract,” a concept originating in the late eighteenth and early nineteenth centuries and “based upon the natural law principle that it is ‘natural’ for parties to perform their bargains or pacts.”<sup>2</sup> In tension with freedom of contract stands the equitable doctrine of unconscionability, which has been around, in one form or another, since antiquity. Scholars have traced the concept back to Roman law.<sup>3</sup> English courts began publishing opinions applying the doctrine as early as 1625,<sup>4</sup> and United States courts still cite an English unconscionability case that is over 250 years old.<sup>5</sup>

In franchising, at first blush, the relevant question appears deceptively simple. Should a franchisee be excused from the franchise agreement’s express terms because they are “unconscionable” -- i.e., simply too “unfair” to be enforced? Lurking in the background, however, are many complexities, such as whether, and to what extent, a court should consider these factors:

- Whether the franchisor had superior bargaining power and, if so, how much “superiority” is needed for the unconscionability doctrine to play a role.
- The level of the franchisee’s business experience, and whether the franchisee was represented by counsel.
- Whether the franchisor was willing to negotiate any of the agreement’s terms, or whether the franchisee even attempted to negotiate.
- Whether the challenged contract terms are widely used in franchising.
- Whether the franchisee had a meaningful choice among different franchise investments with different contract terms.
- Whether the challenged contract terms have any business justification.

Many franchise lawyers, whether they write franchise agreements or litigate franchise cases, may assume that an unconscionability argument is a virtually sure loser -- a “last resort” when all else is likely to fail.<sup>6</sup> But in three recent cases, franchisees persuaded courts to strike down as unconscionable certain mandatory alternative dispute resolution (“ADR”) provisions:

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<sup>1</sup> The authors thank, for their research, assistance and patience, Wiggin and Dana LLP associate Gregory M. McLaughlin and summer associate Robert R. Gatehouse; Schwartz Cooper summer associate Michael J. Fornasiero; and Bartko, Zankel, Tarrant & Miller summer associate Andrew Elliot.

<sup>2</sup> A.H. Angelo and E.P. Ellinger, *Unconscionable Contracts: A Comparative Study of the Approaches in England, France, Germany, and the United States*, 14 LOY. L.A. INT’L & COMP. L. REV. 455 (July 1992); see also Richard J. Hunter, Jr., *Unconscionability Revisited: A Comparative Approach*, 68 N.D. L. REV. 145 (1992).

<sup>3</sup> DAVID G. EPSTEIN, ET AL., MAKING AND DOING DEALS: CONTRACTS IN CONTEXT 428 (2d ed. 2006).

<sup>4</sup> Emmanuel Coll. v. Evans, 1 Ch. R. 18, 21 Eng. Rep. 494 (Ch. 1625) (refusing to enforce mortgage against farmer).

<sup>5</sup> See, e.g., Patapsco Designs, Inc. v. Dominion Wireless, Inc., 276 F. Supp. 2d 472, 478-79 (D. Md. 2003) (citing Earl of Chesterfield v. Janssen, 28 Eng. Rep. 82, 100, 2 Ves. Sen. 125, 155 (Ch. 1750)).

<sup>6</sup> See Alton L. Absher, III & Steven N. Baker, Empirical Study, *Unconscionability Never Really Works, Does It? An Empirical Study of How Courts Have Treated Unconscionability Under UCC Section 2-302*, (WAKE FOREST L. REV., Working Paper No. 4 2005), available at <http://www.law.wfu.edu/prebuilt/Absher-Baker-ES.pdf>. At least one law

- In 2005, a California appellate court in *Independent Association of Mailbox Center Owners, Inc. v. Superior Court*<sup>7</sup> directed the trial court to enter an order striking as unconscionable the provisions in the franchise agreement barring representative or class arbitration, as well as clauses prohibiting arbitrators from granting relief otherwise authorized under a state statute.<sup>8</sup>
- In 2001, a California appellate court in *Bolter v. Superior Court*<sup>9</sup> characterized the franchise agreement between a “large wealthy international” franchisor and several “small” franchisees as a contract of adhesion (a contract that is presented on a take-it or leave-it basis)<sup>10</sup> and therefore held that the “place and manner” restrictions in the franchise agreement’s arbitration clause requiring the franchisee to arbitrate in another state were unconscionable.
- Also in 2001, the United States Court of Appeals for the Ninth Circuit held in *Ticknor v. Choice Hotels International, Inc.*<sup>11</sup> that the arbitration clause in a pre-printed franchise agreement was unconscionable under Montana law “because it required binding arbitration of the weaker bargaining party’s claims, but allowed the stronger bargaining party the opportunity to seek judicial remedies to enforce contractual obligations.”<sup>12</sup>

These decisions raise the question of whether arbitration in franchising may no longer be as “mandatory” -- or pursuant to the franchise agreement’s stated terms -- as it has been in the past.

It is also important to consider whether these recent unconscionability holdings will be extended (in California or elsewhere) beyond the realm of ADR, to invalidate other widely-used contract provisions that franchisees claim are unfair. If so, then we are standing on the threshold of a judicial revolution.

This paper addresses:

- The history and status of the unconscionability doctrine, why the doctrine was ignored for so long, and what, if anything, has changed;
- The recent unconscionability decisions invalidating ADR provisions, whether they were driven by their facts, and whether judicial attitudes toward unconscionability or arbitration have changed, at least in certain courts;

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school professor teaches “his Contracts class to only use unconscionability as a last resort.” *Id.* at n.2. See also Evelyn L. Brown, *The Uncertainty of U.C.C. Section 2-302: Why Unconscionability Has Become a Relic*, 105 COM. L.J. 287, 306 (2000).

<sup>7</sup> 34 Cal. Rptr. 3d 659 (Cal. Ct. App. 2005).

<sup>8</sup> *Id.* at 676.

<sup>9</sup> 104 Cal. Rptr. 2d 888 (Cal. Ct. App. 2001).

<sup>10</sup> See Arthur A. Leff, *Unconscionability and the Code -- The Emperor’s New Clause*, 115 U. PA. L. REV. 485, 504-06 (1967).

<sup>11</sup> 265 F.3d 931 (9th Cir. 2001) (applying Montana law).

<sup>12</sup> *Id.* at 940.

- Whether the recent unconscionability decisions are likely to be extended beyond ADR clauses, and beyond California and the Ninth Circuit; and
- Current strategies for litigating unconscionability claims given recent developments and how to anticipate the next wave of arguments.

Finally, this paper considers the role of unconscionability in the larger “fairness” debate that has raged for many years, at least since the late Harold Brown began to argue that the gross disparity in the power of the franchisor over the franchisee creates a fiduciary obligation.<sup>13</sup> If unconscionability is the next major battleground, what can both sides do to position themselves best for this fight?

## II. SOME STATISTICS

Not surprisingly, most successful unconscionability challenges involve consumer contracts, where an individual who lacked bargaining power signed a contract of adhesion. In 1967, one commentator stated, in dated terms, that in unconscionability cases:

[O]ne runs continually into the old, the young, the ignorant, the necessitous, the illiterate, the improvident, the drunken, the naive and the sick, all on one side of the transaction, with the sharp and hard on the other. Language of quasi-fraud and quasi-duress abounds. Certain whole classes of presumptive sillies like sailors and heirs and farmers and women continually wander on and off stage. Those not certifiably crazy, but nonetheless pretty peculiar, are often to be found.<sup>14</sup>

Consumer cases involving the sale of goods are governed by the Uniform Commercial Code (the “Code” or “UCC”), Section 2-203 of which explicitly permits courts to refuse to enforce unconscionable contract terms. Even in those cases, however, the doctrine has not fared well. The Wake Forest Law Review has compiled an “empirical study” of all cases from 1965 through 2005 in which a party asserted unconscionability under Section 2-302 (the “Empirical Study”). According to this study, in the forty year period covered only 136 cases were decided strictly under Section 2-302.<sup>15</sup> Further, the rate at which litigants have even raised this claim under the Code has been in steady decline since the 1980’s. Among the findings:

- In the 136 “Code cases” during the subject period, the overall success rate for unconscionability claims across the country was 28%, with most of the victories occurring in consumer/adhesion contract cases.<sup>16</sup>
  - However, both California and New York had higher than average success rates, 57% and 33% respectively.<sup>17</sup> Excluding California and New York, the national success rate declined to 22.6%.<sup>18</sup>

<sup>13</sup> See Harold Brown, *Franchising: A Fiduciary Relationship*, 49 TEX. L.R. 650 (1971).

<sup>14</sup> Leff, *supra* note 10, at 532-33.

<sup>15</sup> The Empirical Study included both published and unpublished judicial decisions, but not arbitration decisions and cases in which Section 2-302 supplied the rule of decision by analogy. See, e.g., *Zapatha v. Dairy Mart, Inc.*, 408 N.E.2d 1370, 1375 (Mass. 1980) (a franchising case decided by analogy to Section 2-302).

<sup>16</sup> Absher, *supra* note 6, at 14, 21-22. The study also found that litigants were almost four times more likely to succeed with a Section 2-302 claim in state court rather than in federal court, and so the odds of success could improve based on the choice of forum. *Id.* at 15.

- Of the 136 Code cases, eighty-eight involved commercial parties on both sides of the contract, with one business entity contending that it entered into an unconscionable bargain with the other (as opposed to having an individual consumer make this claim).
  - In these eighty-eight cases, the success rate for unconscionability claims dropped to 12%.<sup>19</sup>
  - That 12% figure includes four cases in which the courts found that the parties had equal bargaining power (a finding that would not be expected in most franchise disputes). The success rate in those “equal bargaining power” cases dipped further to 4.5%.<sup>20</sup>
  - It can be presumed, therefore, that the success rate for cases between two commercial parties where there was *not* a finding of equal bargaining power would rise, but the present version of the Empirical Study does not provide sufficient data to make this precise calculation.<sup>21</sup>

Without claiming to have completely exhausted the field, we found only eleven cases where franchise agreement clauses were held unconscionable out of at least 484 cases in which unconscionability was raised.<sup>22</sup>

### III. BRIEF HISTORY OF THE DOCTRINE

#### A. Equitable Origins

Unconscionability is a question of law to be decided by the court.<sup>23</sup> However, “[u]nconscionable’ is a word that defies lawyer-like definition.”<sup>24</sup> It is akin to pornography: you are supposed to know it when you see it.<sup>25</sup>

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<sup>17</sup> *Id.* at 14.

<sup>18</sup> *Id.*

<sup>19</sup> *Id.* at 18. Specifically, only ten out of eighty-eight claims of unconscionability were successful in disputes between commercial parties on a national basis. *Id.*

<sup>20</sup> *Id.* at 18-20.

<sup>21</sup> The Empirical Study did not isolate the cases in which the courts made an express finding of unequal bargaining power.

<sup>22</sup> One of our summer associates reviewed a total of 484 cases, which were the combined results of searches for the terms “unconscion! w/s franchise,” “franchise & found unconscionable,” and “franchise! w/s unconscionable not w/s not” in the Lexis database “Federal & State Cases, Combined.” Unlike the Empirical Study, these search results were not limited to cases in which Section 2-302 provided the rule of decision. From the total of 484 search results, the courts in eleven cases made a finding of unconscionability. However, the converse is not true, as not each of the other 473 cases expressly rejected the unconscionability argument. Thus, we do not have an exact success rate from these search results.

<sup>23</sup> See *Vance v. Villa Park Mobilehomes Estates*, 42 Cal. Rptr. 2d 723, 729 (Cal. Ct. App. 1995).

<sup>24</sup> JOHN D. CALAMARI & JOSEPH M. PERILLO, *CONTRACTS* 317, 325 (2d ed. 1977).

<sup>25</sup> See *Jacobellis v. Ohio*, 378 U.S. 184, 197 (1964) (Stewart, J. concurring, on the subject of pornography). The parallel was noted, e.g., by Jeffrey W. Stempel, *Arbitration, Unconscionability, and Equilibrium: The Return of Unconscionability Analysis as a Counterweight to Arbitration Formalism*, 19 OHIO ST. J. ON DISP. RESOL. 757, 814 (2004). Similarly, Gellhorn once observed that unconscionability is “little more than a generic concept applicable to

Moreover, a strong judicial reluctance to override freedom of contract -- as the Empirical Study evidences -- is not hard to understand. For markets to function efficiently, all businesses, including franchisors and franchisees, generally prefer predictable outcomes in contract disputes, at least at the time of contracting.<sup>26</sup> Freedom of contract has been ascendant, and modern courts, quite rightly, are usually reluctant to undo stated contract terms. Accordingly, any party claiming that its own bargain is too unfair to be enforced usually faces a very high burden of persuasion.<sup>27</sup>

There is no objective or simple test for determining when a court should curtail parties' freedom to make a bad deal, or provide an "escape hatch" from the consequences of an express bargain. For hundreds of years, courts have struggled without success to find the right formula for determining that a contract term is unconscionable. Some classic judicial formulations include:

- That the provision is one that "no man in his senses and not under delusion would make on one hand, and as no honest and fair man would accept on the other; which are unequitable and unconscientious bargains."<sup>28</sup>
- That the provision would license behavior sufficiently outrageous to "shock the conscience" of the court.<sup>29</sup>
- "That [n]o decent, fair minded person would view the ensuing result without being possessed of a profound sense of injustice . . . ."<sup>30</sup>
- That the provision "affronts the sense of decency."<sup>31</sup>

These pronouncements, though oft-recited, provide little meaningful guidance. Many courts simply weigh certain factors, often in a frustratingly *ad hoc* manner.<sup>32</sup> Some factors that

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various fact situations." Ernest Gellhorn, *Limitations on Contract Termination Rights -- Franchise Cancellations*, 1967 DUKE L.J. 465, 490 (1967).

<sup>26</sup> See, e.g., *S.J. Amoroso Constr. Co. v. United States*, 12 F.3d 1072, 1080 (Fed. Cir. 1993).

<sup>27</sup> This reluctance may be attributed, partly, to the Law and Economics ("L&E") school of thought. Beginning in the 1960s, L&E adherents criticized judicial doctrines that work against a free market. "In a nutshell, the standard L&E analysis of form contract posits that market forces will produce efficient form contract terms that on the whole benefit not only contract drafters (i.e., sellers) but also adhering parties (i.e., buyers or consumers) . . . . If persuaded by the L&E analysis, courts no longer need to worry about things like bargaining power, consent, understanding, or fairness in the individual contract disputes. The forces of the market economy will produce standard form contract terms that are generally efficient. Therefore, strict enforcement of these terms became the 'right' thing for courts to do, irrespective of any analysis of the particular context of the dispute before the court or potential consequences to the disputants." Stempel, *supra* note 25, at 823.

<sup>28</sup> *Earl of Chesterfield v. Janssen*, 28 Eng. Rep. 82, 100, 2 Ves. Sen. 125, 155 (Ch. 1750).

<sup>29</sup> *Eyre v. Potter*, 56 U.S. (60 How.) 42, 60 (1853). The application of unconscionability to conduct, or behavior, and not merely to contract terms, as suggested by this definition, is a recurring theme in the law of unconscionability.

<sup>30</sup> Samuel Williston, *A Treatise on the Law of Contracts*, 51-52 (3d ed. Jaeger 1972) (quoting *Carlsen v. Hamilton*, 332 P.2d 989, 990-91 (Utah 1958)).

<sup>31</sup> CALAMARI & PERILLO, *supra* note 24, at 325 (internal quotations and citations omitted).

<sup>32</sup> Lawyers who draft or defend franchise agreements tend to disapprove of the multi-factor approach, since lack of precise definition and the existence of multiple factors generally create uncertainty and provide too much leeway for creative argument in litigation. Even for the franchisee, ambiguity at the time of contracting can be a double-edged sword. We doubt that franchisees actually prefer unpredictability as to what their contract means, but we suspect that some franchisees settle for ambiguity at the time of contracting in the hope of leveraging a better result later, if a dispute arises.

may lead to a finding of unconscionability include: “(1) absence of meaningful choice; (2) great inequality of bargaining power; (3) inclusion of terms which might result in surprise, hardship or oppression; [and] (4) circumstances where race, language, literacy, ethnicity or education are significant factors in determining the nature of the bargain.”<sup>33</sup>

## **B. Codification**

### **1. Section 2-302 of the Uniform Commercial Code**

Recent codification has not clarified matters. Section 2-302 of the UCC, the subject of the Empirical Study, was widely adopted in the 1960s and brought unconscionability into the mainstream of commercial law,<sup>34</sup> but did not supply a cohesive definition.<sup>35</sup> This section, and its comments, are often cited by analogy in franchising and other non-sales cases.<sup>36</sup> Section 2-302 provides that:

(1) If the court as a matter of law finds the contract or any clause of the contract to have been unconscionable at the time it was made, the court may refuse to enforce the contract, or may enforce the remainder of the contract without the unconscionable clause, or it may so limit the application of any unconscionable clause as to avoid any unconscionable result.

(2) When it is claimed or appears to the court that the contract or any clause therein may be unconscionable the parties shall be afforded a reasonable opportunity to present evidence as to its commercial setting, purpose and effect to aid the court in making the determination.

Official Comment 1 to Section 2-302 states that:

The basic test is whether, in light of the general commercial background and the commercial needs of the particular case, the clauses involved are so one-sided as to be unconscionable under the circumstances existing at the time of the making of the contract.<sup>37</sup>

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<sup>33</sup> Hunter, *supra* note 2, at 152. The standards enunciated in Section 4 of the Uniform Consumer Sales Practices Act, *infra* note 52, might also be asserted in any unconscionability case.

<sup>34</sup> U.C.C. § 2-302 (quoting Hunter, *supra* note 2, at 149-50). This extension was not unexpected. See Leff, *supra* note 10, at 486 n.4 (“It has been suggested that the Code’s unconscionability doctrine will not be limited to the law of Sales for long, but is likely speedily to enter the general law of contracts”) (citations omitted).

<sup>35</sup> According to CALAMARI & PERILLO, Section 2-302 is “designed to . . . encourage courts to openly strike down provisions of the type which had previously been denied enforcement at law largely through covert means.” CALAMARI & PERILLO, *supra* note 24, at 321. See also Leff, *supra* note 10, at 487 (UCC Section 2-302 “makes nothing clear about the meaning of ‘unconscionable’ except perhaps that it is pejorative”). U.C.C. § 2-302 cmt.1 (2005) (“This Section is intended to allow the court to pass directly on the unconscionability of the contract or particular clause therein and to make a conclusion of law as to its unconscionability. The basic test is whether, in light of the general commercial background and the commercial needs of the particular trade or case, the clauses involved are so one-sided as to be unconscionable under the circumstances existing at the time of the making of the contract.”).

<sup>36</sup> See, e.g., *Zapatha v. Dairy Mart, Inc.*, 408 N.E.2d 1370, 1375, 1376 n.12 (Mass. 1980). See also Absher, *supra* note 6, at 20 (stating that this test was cited as the governing law in approximately 30% of the reported cases from 1965 to 2005 that were decided under the Code itself).

<sup>37</sup> The commentary did not explain how a subsequent “result” could be judged “under the circumstances existing at the time of making the contract” -- a dilemma that we explore in Section VI of this paper.

The seminal case interpreting Section 2-302 is the 1965 decision of the United States Court of Appeals for the D.C. Circuit, *Williams v. Walker-Thomas Furniture Co.*,<sup>38</sup> holding that unconscionability means “an absence of meaningful choice” combined with “contract terms which are unreasonably favorable to the other party.”<sup>39</sup> This standard would appear to set a lower bar than the “shocking of the conscience” or “appearance of delusion” tests. However, in seeming contradiction, the Official Comments specifically admonish that: “[t]he principle is one of the prevention of oppression and unfair surprise and not of disturbance of allocation of risks because of superior bargaining power.”<sup>40</sup> In any event, despite some predictions to the contrary, Section 2-302 did not lead to a surge in unconscionability findings.

**a. “Disturbance of Risks”**

A significant majority of courts appear to have taken seriously the Code’s admonition that unconscionability should not be used to invalidate contract terms merely because one of the parties lacked business sophistication and made an unwise bargain. For example, a New York court refused to “establish rights [on the] lessee franchisee’s behalf other than those he contracted for” and refused to hold that a lease agreement was an unenforceable contract of adhesion.<sup>41</sup> Speaking broadly, the court held that:

It is not [the court’s] function to guarantee every businessman’s success in his enterprise, or to protect him from entering into improvident or ill-advised contracts, or to relieve him from contracts freely negotiated, that prove to be onerous. It cannot be denied that the vitality of our marketplace is derived to a great degree from the time-honored caveat that the individual must enjoy the ‘freedom of contract’ subject only to the obvious limitation of legality, fraud and lack of capacity.<sup>42</sup>

**b. Substantive vs. Procedural Unconscionability**

Section 2-302 suggests that unconscionability has both substantive and procedural elements:

- Substantive unconscionability involves the contract terms themselves and asks whether those are “commercially reasonable”<sup>43</sup> or “simply too unfair to merit judicial

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<sup>38</sup> 350 F.2d 445 (D.C. Cir. 1965).

<sup>39</sup> *Id.* at 449.

<sup>40</sup> U.C.C. § 2-302 cmt. 1 (1991); see also *Campbell Soup Co. v. Wentz*, 172 F.2d 80 (3d Cir. 1948); *Hunter*, *supra* note 2, at 149. This comment indicates strong reluctance to find unconscionability based merely upon superior bargaining power and reflects considerable deference to the principle of freedom of contract, discussed above.

<sup>41</sup> *Texaco Inc. v. A.A. Gold Inc.*, 357 N.Y.S.2d 951, *aff’d*, 358 N.Y.S.2d 973 (N.Y. Sup. Ct. 1974). See also *Info. Leasing Corp. v. King*, 800 N.E.2d 73, 77 (Ohio Ct. App. 2003) (“King’s argument that she lacked commercial sophistication . . . fails here . . . because the lack of sophistication of one commercial party to the agreement is not a sufficient basis to invalidate a forum-selection clause in a commercial contract. Thus, even if King truly were inexperienced in business matters, despite owning her own business for twenty years, her lack of knowledge of legal terms and unfamiliarity with lease agreements could not invalidate the forum-selection clause.”); *Saturna v. Bickley Constr. Co.*, 555 S.E.2d 825, 827 (Ga. Ct. App. 2001) (“[L]ack of sophistication or economic disadvantage of one attacking arbitration will not amount to unconscionability.”).

<sup>42</sup> *A.A. Gold*, 357 N.Y.S.2d at 956.

<sup>43</sup> *Collins v. Click Camera & Video, Inc.*, 621 N.E.2d 1294, 1299 (Ohio Ct. App. 1993).

enforcement,” “no matter how openly set forth or voluntarily accepted.”<sup>44</sup>

- “Procedural” unconscionability challenges include those based on “bargaining naughtiness,”<sup>45</sup> focusing on the circumstances surrounding contract formation.<sup>46</sup> It is concerned, therefore, with “not only the employment of sharp practices and the use of fine print and convoluted language, but [also with] a lack of understanding and an inequality of bargaining power.”<sup>47</sup>

However, “the cases do not neatly fall into these two divisions.”<sup>48</sup> In some jurisdictions, however, courts have made clear that they require both “procedural” and “substantive” unconscionability to invalidate a contract provision,<sup>49</sup> but it is not yet universally established whether, or to what extent, both substantive and procedural unconscionability must be present.<sup>50</sup>

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<sup>44</sup> Stempel, *supra* note 25, at 794. See, e.g., *Jacada (Europe) Ltd. v. Int’l Mktg. Strategies*, 401 F.3d 701 (6th Cir. 2005) (upholding arbitrator’s finding that a limited liability provision in a software distribution agreement was “substantively unreasonable”), *cert. denied*, \_\_\_ U.S. \_\_\_, 126 S. Ct. 735 (2005); *Alexander v. Anthony Int’l, L.P.*, 341 F.3d 256, 267-71 (3d Cir. 2003) (thirty-day limit for presenting claim to employer, limitation on employees’ relief, requirement that parties bear their own arbitration costs, and requirement that losing party pay arbitration costs, were substantively unconscionable) (Virgin Islands law); *Gianni Sport Ltd. v. Gantos, Inc.*, 391 N.W.2d 760, 762-63 (Mich. Ct. App. 1986) (affirming holding that cancellation clause entitling one party to cancel at any time, which could leave seller in the “untenable position of absorbing the loss or negotiating with the buyer to accept the goods at a reduced price” was not reasonable and therefore unconscionable); *Ashland Oil, Inc. v. Donahue*, 223 S.E.2d 433, 438 (W. Va. 1976) (ten-day cancellation clause in a dealer agreement substantively unconscionable because it was only available to the dealer).

<sup>45</sup> Leff, *supra* note 10, at 487.

<sup>46</sup> *Zapatha v. Dairy Mart, Inc.*, 408 N.E.2d 1370, 1377 & n.13 (Mass. 1980); *Days Inns Worldwide, Inc. v. Mehta*, No. CV 304-092, 2005 U.S. Dist. LEXIS 20803, at \*11 (S.D. Ga. Sept. 7, 2005).

<sup>47</sup> 1 E. Allan Farnsworth, *FARNSWORTH ON CONTRACTS* § 4.28 at 506-07 (footnotes omitted). The substance/procedure distinction is illustrated by the following discussion of oppressive arbitration clauses: “[A]n arbitration provision may provide for a perfectly reasonable and even-handed arbitration scheme in the event of disputes but be the product of . . . bargaining naughtiness . . . . The clause may be in typeface too small to be read without a microscope. It may be in [sic] written in complex legalese or other jargon incomprehensible even to the lay reader armed with a microscope. It may be stapled to the contract as an ‘endorsement’ after execution and never seen by the party that signed the overall contract. The execution of the ‘container contract’ (the contract containing the arbitration term) may have been attended by an environment designed to distract the adhering party or to pressure him or her into reviewing and signing quickly (e.g., ‘Ms. Unsophisticated, Deferential Consumer, there are twenty-eight people in line behind you. Do you want the Miracle Widget or don’t you? If you do, please just sign the contract so that I can wait on the other customers.’).” Stempel, *supra* note 25, at 795-96.

<sup>48</sup> See Celeste M. Hammond, *The (Pre) (As) Sumed “Consent” of Commercial Binding Arbitration Contracts: An Empirical Study of Attitudes and Expectations of Transactional Lawyers*, 36 J. MARSHALL L. REV. 589, 602-03 (2003); Hunter, *supra* note 2, at 152 (quoting CALAMARI & PERILLO, *supra* note 24). See also Arthur M. Kaufman and Ross M. Babbitt, *The Mutuality Doctrine in the Arbitration Agreements: The Elephant in the Road*, 22 FRANCHISE L.J. 101, 104 (2002). The Empirical Study reported at pp. 20-21, that only about 14% of the Code cases from 1965 to 2005 had followed some version of this approach, but that the use of a substantive/procedural approach was increasing.

<sup>49</sup> See Hammond, *supra* note 48, at 602-03.

<sup>50</sup> The Empirical Study found that in thirty-eight cases from 1965 to 2005, courts found unconscionability using this two-pronged approach, and only eighteen of those cases found both procedural and substantive unconscionability. Absher, *supra* note 6, at 23. Very few of the cases used a sliding scale to either find, or reject, a finding of unconscionability. *Id.*

## 2. Acceptance by the Restatement (Second) of Contracts and Inclusion in Uniform Acts

In the wake of Section 2-302, the unconscionability doctrine was included in Section 208 of the Restatement (Second) of Contracts, which is substantively identical to Section 2-302(1) of the Code.<sup>51</sup>

Other codifications include the Uniform Consumer Sales Practices Act, and the Uniform Consumer Credit Code. These statutes may be relevant by analogy in challenging specific terms, e.g. price terms, even where the statutes do not govern.<sup>52</sup>

## 3. Little FTC Acts and State Franchise and Dealer Laws

The doctrine has also been incorporated into various states' franchise and dealer laws<sup>53</sup> and "Little FTC Acts."<sup>54</sup> These statutes, where applicable, expand the doctrine to proscribe unconscionable *conduct* in the performance of the franchise relationship, although, like the other codifications, they do not define unconscionability.

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<sup>51</sup> The First Restatement of Contracts did not explicitly acknowledge the doctrine of unconscionability. The Reporter's Note to Section 208 of the Restatement (Second) adds that "gross inequality of bargaining power, together with terms unreasonably favorable to the stronger party, may confirm indications that the transaction involved elements of deception or compulsion, or may show that the weaker party had no meaningful choice, no real alternative, or did not in fact assent or appear to assent to the unfair terms." RESTATEMENT (SECOND) OF CONTRACTS, § 208 cmt.

<sup>52</sup> Section 4 of the Uniform Consumer Sales Practices Act provides, in relevant part, that unconscionability should be found where the supplier has reason to know:

- (1) that he took advantage of the inability of the consumer reasonably to protect his interests because of his physical infirmity, ignorance, illiteracy, inability to understand the language of an agreement, or similar factors;
- (2) that when the consumer transaction was entered into the price grossly exceeded the price at which similar property or services were readily obtainable in similar transactions by like consumers;
- (3) that when the consumer transaction was entered into the consumer was unable to receive a substantial benefit from the subject of the transaction;
- (4) that when the consumer transaction was entered into there was no reasonable probability of payment of the obligation in full by the consumer;
- (5) that the transaction he induced the consumer to enter into was excessively one-sided in favor of the supplier; or
- (6) that he made a misleading statement of opinion on which the consumer was likely to rely to his detriment.

UNIF. CONSUMER SALES PRACTICES ACT § 4 (1970). Similarly, the Uniform Consumer Credit Code provides, in relevant part, that "[t]he competence of the Consumer any deception or coercion practiced upon him, the nature and extent of the legal advice received by him, and the value of the consideration are relevant to the issue of unconscionability." UNIF. CREDIT CODE § 1.107 (1974).

See also generally CALAMARI & PERILLO, *supra* note 24, at 327-28.

<sup>53</sup> See, Appendix 1 for a list of relevant statutes throughout the country. The authors have endeavored to make this list as complete as possible.

<sup>54</sup> See, Appendix 2 for a list of relevant statutes throughout the country. The authors have endeavored to make this list as complete as possible.

## IV. UNCONSCIONABILITY IN FRANCHISING

### A. The Fairness Debate

Calls for judicial intervention to protect franchisees by declaring franchise agreement terms unconscionable are not new. As early as 1967, the argument was made that clauses permitting termination without cause should be unenforceable.<sup>55</sup> That early call went nowhere.<sup>56</sup> In 1971, Harold Brown strenuously argued that numerous common franchise agreement provisions were the unconscionable result not only of franchisors' superior bargaining power, but also of their use of this power in the franchise sales process to impose very harsh terms upon unwary franchisees.<sup>57</sup> Among the terms that Brown denounced were:

restrictions on transfer, covenants not to compete, and termination penalties; in particular compelling the franchisor who wants to repurchase a franchise to offer the franchisee the fair value of his business, with no compulsion on the franchisee to sell, and permitting the franchisee who wants to sell or make a gift of his franchise to do so to a person of his own choice who need be no more qualified than he was when he entered into the agreement.<sup>58</sup>

In Harold Brown's view, all of these terms combined to threaten the franchisee with a loss of equity upon termination, which was itself a constant threat hanging over the franchisee, and therefore gave the franchisor the maximum leverage over the franchisee throughout the entire relationship. As Brown elaborated:

The threat [to the franchisee's equity] is, of course, buttressed by the standard covenant not to compete, with one or more preemptive rights, all designed to assure that the franchisee will not terminate for fear of losing his investment and equity. The franchisor may even have an option to acquire the equipment at depressed value. Additional control over the franchisee's equity is assured through arbitrary control over the right to transfer, a right of first refusal in case of sale, arbitration of all disputes at the franchisor's home office, and even compulsory resale under a one-sided formula. Moreover, since the franchisor always drafts the franchise agreement and adamantly declines to assent to any modification, he has an untrammelled opportunity to assure unfair self-

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<sup>55</sup> Gellhorn, *supra* note 25, at 465. Five years after Gellhorn called for an active approach to unconscionability in franchising, there was little or no evidence that any courts had adopted his recommendation. See Charles M. Hewitt, *Good Faith or Unconscionability -- Franchisee Remedies for Termination*, 29 BUS. LAW. 227 (1973).

<sup>56</sup> Brown, *supra* note 13. Note, however, that some State Statutes now require good cause for franchise termination. For overviews and citations to representative statutes, see Business Franchise Guide (CCH) ¶¶ 4015 (Alabama), 4025 (Alaska), 4035 (Arizona), 4040 (Arkansas), 4050 (California), 4065 (Colorado), 4070 (Connecticut), 4080 (Delaware), 4095 (Florida), 4105 (Georgia), 4110 (Hawaii), 4125 (Idaho), 4130 (Illinois), 4140 (Indiana), 4150 (Iowa), 4165 (Kansas), 4175 (Kentucky), 4185 (Louisiana), 4195 (Maine), 4205 (Maryland), 4215 (Massachusetts), 4220 (Michigan), 4235 (Minnesota), 4245 (Mississippi), 4250 (Missouri), 4265 (Montana), 4270 (Nebraska), 4285 (Nevada), 4295 (New Hampshire), 4300 (New Jersey), 4315 (New Mexico), 4325 (New York), 4335 (North Carolina), 4345 (North Dakota), 4355 (Ohio), 4365 (Oklahoma), 4375 (Oregon), 4385 (Pennsylvania), 4395 (Rhode Island), 4415 (South Dakota), 4425 (Tennessee), 4435 (Texas), 4445 (Utah), 4455 (Vermont), 4465 (Virginia), 4470 (Washington), 4485 (West Virginia), 4490 (Wisconsin), 4505 (Wyoming), 4510 (District of Columbia) & 4530 (Virgin Islands) (even-numbered paragraphs summarize "good cause" termination requirements in laws of general franchise applicability).

<sup>57</sup> Brown, *supra* note 13, at 650.

<sup>58</sup> *Id.* at 671.

preferences. Merely to illustrate, the right of first refusal is often aided by a prohibition on advertising the sale of the franchise until after the franchisor has refused the offer.<sup>59</sup>

We will not attempt to document every twist and turn in the “franchise fairness” debate from 1971 to the present, including efforts in litigation to impose upon franchisors a duty of competence<sup>60</sup> and/or fiduciary duties,<sup>61</sup> and to expand the scope of the implied covenant of good faith and fair dealing.<sup>62</sup> Suffice it to say that the recent surge of the unconscionability doctrine in California and the Ninth Circuit is the latest chapter in this saga and, regardless of the ultimate outcome, franchisees and franchisors are likely to spend substantial time and money litigating the doctrine in the coming years as they have in the past with respect to other “franchise fairness” arguments.

## **B. Earlier Franchise Cases**

In 1980, the Massachusetts Supreme Court provided a relatively early and somewhat representative analysis of unconscionability in franchising in *Zapatha v. Dairy Mart, Inc.*, where Dairy Mart terminated a franchise agreement after a franchisee refused to enter a new franchise agreement that he perceived as more onerous than his previous one.<sup>63</sup> The franchisee then claimed that Dairy Mart’s contractual ability to terminate him without cause was unconscionable. The Massachusetts Supreme Court concluded that the doctrine of unconscionability applied “to all aspects of the franchise agreement, not by subjecting the franchise relationship to the provisions of the sales article [of the UCC] but rather by applying the stated principles by analogy.”<sup>64</sup> However, the court reversed the trial court’s finding of unconscionability due to a lack of both procedural and substantive unconscionability. The court found that:

- “The termination provision was neither obscurely worded, nor buried in fine print in the contract;”<sup>65</sup>
- “The provision was specifically pointed out to [the franchisee] before it was signed; [the franchisee] testified that he thought the provision was ‘straightforward,’ and [the franchisee] declined the opportunity [recommended by Dairy Mart] to take the agreement to a lawyer for advice;”<sup>66</sup>

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<sup>59</sup> *Id.* at 662.

<sup>60</sup> See, e.g., *A.J. Temple Marble & Tile, Inc. v. Union Carbide Marble Care, Inc.*, 618 N.Y.S.2d 155 (N.Y. Sup. Ct. 1994), *aff’d*, 214 A.D.2d 473, (N.Y. App. Div. 1995), *aff’d & modified in part*, 663 N.E.2d 890 (N.Y. 1996).

<sup>61</sup> See, e.g., *Bixby’s Food Sys., Inc. v. McKay*, 985 F. Supp. 802, 808 (N.D. Ill. 1997) (franchise relationship does not create fiduciary relationship); *Picture Lake Campground, Inc. v. Holiday Inns, Inc.*, 497 F. Supp. 858, 869 (E.D. Va. 1980) (“A franchise relationship is inherently a business relationship, not a fiduciary relationship”).

<sup>62</sup> See e.g., Joseph Schumacher, *Exercise of Discretion -- Laws Affecting a Franchisor’s Exercise of Discretion and Avoiding Claims in the Exercise of Discretion*, INT’L FRANCHISE ASS’N LEGAL SYMPOSIUM at 5-6 (May 2005). Mr. Schumacher is Ms. Appleby’s partner at Wiggin and Dana LLP.

<sup>63</sup> *Zapatha v. Dairy Mart, Inc.*, 408 N.E.2d 1370, 1376-77 (Mass. 1980).

<sup>64</sup> *Id.* at 1375.

<sup>65</sup> *Id.* at 1377.

<sup>66</sup> *Id.*

- “[A] person of [the franchisee’s] business experience and education<sup>67</sup> should not have been surprised by the termination provision and . . . there was no element of unfairness in the inclusion;”<sup>68</sup> and
- “[T]here was no oppression in the inclusion of a termination clause in the franchise agreement.”<sup>69</sup>

The court also noted that the UCC “itself implies that a contract provision allowing termination without cause is not per se unconscionable.”<sup>70</sup>

### C. Franchisor Successes

Since *Zapatha*, the unconscionability bar in franchise cases has generally been set quite high. For example, in *Original Great American Chocolate Chip Cookie Co. v. River Valley Cookies, Ltd.*, the United States Court of Appeals for the Seventh Circuit, applying Illinois law, pronounced that “[t]he presence of a commercially unreasonable term, in the sense of a term that no one in his right mind would have agreed to, can be relevant to drawing an inference of unconscionability but cannot be equated to it.”<sup>71</sup> Likewise, in *We Care Hair Development, Inc. v. Engen*, the Seventh Circuit summarily held in 1999 that fifty-three hair-cutting “franchisees were not vulnerable consumers or helpless workers, but rather business people who bought a franchise,” and on that basis alone rejected an unconscionability defense to enforcement of the franchise agreement’s arbitration clause.<sup>72</sup>

As these cases illustrate, to date it has generally been a pretty safe bet that a franchisor will defeat an unconscionability claim. A review of a string of challenges to the Subway franchise agreements in the 1990s further illustrates this point and is appropriate as a contrast

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<sup>67</sup> The franchisee was a high school graduate with some college experience who had been an operations manager at a metal finishing plant. *Id.* at 1372.

<sup>68</sup> *Id.* at 1377.

<sup>69</sup> *Id.* Citing the requirement that Dairy Mart had to purchase the franchisee’s inventory on relatively favorable terms in the case of termination without cause, the court further concluded that the franchisee “failed to sustain [the] burden of showing that the agreement allocated the risks and benefits connected with termination in an unreasonably disproportionate way and that the termination provision was not reasonably related to legitimate commercial needs of Dairy Mart.” *Id.*

<sup>70</sup> *Id.* at 1376.

<sup>71</sup> 970 F.2d 273, 281 (7th Cir. 1992) (note that the franchisees in this case did not raise unconscionability as a defense); see also *We Care Hair Dev., Inc. v. Engen*, 180 F.3d 838 (7th Cir. 1999) (arbitration clause in franchise agreement not unconscionable under Illinois law even though, when coupled with cross-default provision of sublease, franchisee could be forced to arbitrate claims while franchisor affiliates could use courts to evict franchisee). Ms. Appleby’s law firm represented *We Care Hair Development, Inc.* in that case.

<sup>72</sup> 180 F.3d 838, 843 (7th Cir. 1999) (internal quotations omitted) (quoting *Original Great Am. Chocolate Chip Cookie*, 970 F.2d at 281). The arbitration clauses in *We Care Hair*, when coupled with cross-default provision of real estate subleases, required the franchisees to arbitrate claims while franchisor affiliates could use courts to evict them. The argument for unconscionability based on this lack of mutuality was rejected solely because the court had characterized the owners of these hair salons as business persons. Thus, the Seventh Circuit reached the opposite result from the Ninth Circuit in *Ticknor v. Choice Hotels International, Inc.*, 265 F.3d 931, 935-41 (9th Cir. 2001), where a similar lack of mutuality in an arbitration clause resulted in an unconscionability finding. In *Ticknor*, the majority avoided the problem of characterizing the franchisees, who owned two hotels, as a business person, but the court instead predicted, in a diversity case, that the Montana Supreme Court would not limit the unconscionability defense to consumer transactions. The dissent in *Ticknor* would have denied any relief to these franchisees precisely because the “plaintiffs are not unsophisticated ‘consumers’ under any definition of the term and this is not a consumer transaction.” *Id.* at 942-43.

to the recent California ADR cases. In 1996, the United States Supreme Court in *Doctor's Associates, Inc. v. Casarotto* invalidated a Montana statute with particularized requirements for arbitration clauses not applicable to other contract terms.<sup>73</sup> The Court acknowledged that the Federal Arbitration Act ("FAA") generally requires enforcement of arbitration agreements, with unconscionability being an exception to that rule.<sup>74</sup> Less than a month later, in *Doctor's Associates, Inc. v. Stuart*,<sup>75</sup> the Second Circuit addressed and rejected franchisees' claims that the arbitration provisions in the franchise agreements were unconscionable. The franchisees had claimed that the standard Subway arbitration clause, as enforced by the franchisor, was "unconscionable because the franchise agreement does not disclose that: (1) the American Arbitration Association ("AAA") charges as much as \$5,000 for filing and administration fees; (2) the high cost of arbitrating in Connecticut -- including travel and lodging expenses for the franchisee and his or her attorney -- necessitates the franchisee to win the arbitration to break even financially; (3) the franchisee must pay half of the hourly charges of the arbitrators, who are often attorneys with high-priced rates; (4) the AAA relies on [the franchisor] to provide it with repeat business and thus has a bias in favor of [the franchisor]; and (5) [the franchisor] primarily resolves its disputes with franchisees by filing, or threatening to file, eviction lawsuits in the name of its affiliated leasing companies, instead of arbitrating as represented by the franchise agreements."<sup>76</sup>

The court rejected the franchisees' unconscionability claims, noting that there was no "unfair surprise or oppression," because the agreement's language made clear that the franchisees would have to travel to the specified arbitration site and pay their arbitration costs.<sup>77</sup> The court cited Supreme Court precedent that arbitration "forum selection clauses are not unconscionable."<sup>78</sup> It also concluded that the franchisees had "failed to present any credible evidence" of arbitrator bias, and that the franchisees had failed to establish that any franchisor affiliate had ever threatened to evict them.<sup>79</sup>

Next, in *Doctor's Associates, Inc. v. Distajo*<sup>80</sup> and *Doctor's Associates, Inc. v. Jabush*,<sup>81</sup> the Second Circuit rejected two additional (and related) unconscionability attacks on the Subway arbitration agreement. In these cases, unlike in *Stuart*, the franchisor's leasing affiliate had actually sued to evict the franchisees. The court nonetheless found no evidence of unconscionability. Noting that "[a]n unconscionable bargain is one which 'no man in his senses and not under delusion would make on the one hand, and . . . no honest and fair man would accept on the other,'"<sup>82</sup> the court found that the arbitration clause and cross-default provision permitting sublease termination had been fully disclosed, and that they "did not unfairly surprise

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<sup>73</sup> 517 U.S. 681 (1996). Ms. Appleby's law firm represented Doctor's Associates, Inc. in this case.

<sup>74</sup> *Id.* at 683. See also 9 U.S.C. Section 2, which declares that written provisions for arbitration are "valid, irrevocable, and enforceable, save upon such grounds as exist at law or in equity for the revocation of any contract." The Court held that "generally applicable contract defenses, such as fraud, duress, or unconscionability, may be applied to invalidate arbitration agreements without contravening § 2." *Casarotto*, 517 U.S. at 687.

<sup>75</sup> 85 F.3d 975 (2d Cir. 1996). Ms. Appleby's law firm represented Doctor's Associates, Inc. in this case.

<sup>76</sup> *Id.* at 980.

<sup>77</sup> *Id.*

<sup>78</sup> *Id.*

<sup>79</sup> *Id.* at 981.

<sup>80</sup> 107 F.3d 126 (2d Cir. 1997). Ms. Appleby's law firm represented Doctor's Associates, Inc. in this case.

<sup>81</sup> 89 F.3d 109 (2d Cir. 1996). Ms. Appleby's law firm represented Doctor's Associates, Inc. in this case.

<sup>82</sup> *Id.* at 113 (quoting *Hume v. United States*, 132 U.S. 406, 411 (1889)).

and oppress” the franchisees.<sup>83</sup> The Third, Fourth, Seventh, Eighth, and Eleventh Circuits have similarly rejected unconscionability challenges to arbitration provisions in franchise agreements.<sup>84</sup>

#### **D. Other Challenges by Franchisees (that Usually Failed)**

Another fertile, and related, area for unconscionability challenges involves franchisor attempts to preclude class arbitrations.<sup>85</sup> Federal courts outside of the Ninth Circuit have generally held that the preclusion of class arbitrations is not unconscionable.<sup>86</sup>

Franchisees, dealers and licensees have also challenged as unconscionable the lack of a requirement that the franchisor repurchase inventory after termination;<sup>87</sup> damage caps and liquidated damages provisions;<sup>88</sup> forum selection clauses;<sup>89</sup> releases of liability;<sup>90</sup> choice of law clauses;<sup>91</sup> waivers of punitive damages;<sup>92</sup> waivers of a trial by jury;<sup>93</sup> provisions allowing

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<sup>83</sup> *Id.* (citations omitted).

<sup>84</sup> See *Choice Hotels, Inc. v. Chewl's Hospitality, Inc.*, 91 Fed. App'x 810 (4th Cir. 2003) (unpublished) (Maryland law); *Shaffer v. Graybill*, 68 Fed. App'x 374 (3d Cir. 2003) (not precedential) (Pennsylvania law); *Barker v. Golf U.S.A., Inc.*, 154 F.3d 788 (8th Cir. 1998) (Oklahoma law); *Original Great Am. Chocolate Chip Cookie Co. v. River Valley Cookies, Ltd.*, 970 F.2d 273, 281 (7th Cir. 1992) (Illinois law); *Golden v. Mobil Oil Corp.*, 882 F.2d 490 (11th Cir. 1989) (Florida law); *Amoco Oil Co. v. Ashcraft*, 791 F.2d 522 (7th Cir. 1986) (Indiana law).

<sup>85</sup> Determining unconscionability is a task for the arbitrator when the challenge is to the contract terms generally and for the court when the question addresses the arbitration provision itself. See *Buckeye Check Cashing, Inc. v. Cardegna*, \_\_\_ U.S. \_\_\_, 126 S.Ct. 1204, 1210 (2006) (“regardless of whether the challenge is brought in federal or state court, a challenge to the validity of the contract as a whole, and not specifically to the arbitration clause, must go to the arbitrator”); *Prima Paint Corp. v. Flood & Conklin Mfg. Co.*, 388 U.S. 395 (1967) (court may decide fraud in the inducement claims going to the arbitration clause itself but that arbitrator must resolve fraud in the inducement claims concerning the contract generally).

<sup>86</sup> See, Appendix 3 for a list of representative cases.

<sup>87</sup> See, e.g., *W.L. May Co. v. Philco-Ford Corp.*, 543 P.2d 283 (Or. 1975).

<sup>88</sup> See, e.g., *Cognitest Corp. v. Riverside Publ'g Co.*, 107 F.3d 493 (7th Cir. 1997); *JET, Inc. v. Shell Oil Co.*, No. 02 C 2289, 2002 WL 31641627 (N.D. Ill. Nov. 22, 2002), *aff'd*, 381 F.3d 627 (7th Cir. 2004); *Stanley A. Klopp, Inc. v. John Deere Co.*, 510 F. Supp. 807 (E.D. Pa. 1981), *aff'd*, 676 F.2d 688 (3d Cir. 1982); *Phillips Mach. Co. v. LeBlond*, 494 F. Supp. 318 (N.D. Okla. 1980).

<sup>89</sup> See, e.g., *Doctor's Assocs., Inc. v. Neal*, Nos. 96-7722 & 97-7582, Bus. Franchise Guide (CCH) ¶ 11,330 (2d Cir. Feb. 5, 1998) (Ms. Appleby's law firm represented Doctor's Associates, Inc. in this case); *Medicap Pharmacies v. Faidley*, 416 F. Supp. 2d 678, (S.D. Iowa 2006); *G&R Moojestic Treats, Inc. v. Maggiemoo's Int'l LLC*, No. 03 Civ. 10027(RWS), 2004 WL 1172762, (S.D.N.Y. May 27, 2004); *Tallow Tree, Inc. v. Candleman Corp.*, CIV-98-0039-PHX-ROS, Bus. Franchise Guide (CCH) ¶ 11,452 (D. Ariz. June 1, 1998); *Karlberg European Tanspa, Inc. v. JK-Josef Kratz Vertriebsgesellschaft MbH*, 699 F. Supp. 669 (N.D. Ill. 1985); see also *Kubis & Perszyk Assocs., Inc. v. Sun Microsystems, Inc.*, 680 A.2d 618 (N.J. 1996) (forum selection clauses presumptively unconstitutional under New Jersey Franchise Practices Act).

<sup>90</sup> See, e.g., *Wells v. Entre Computer Ctrs., Inc.*, 915 F.2d 1566 (Table), 1990 WL 146981 (4th Cir. Oct. 5, 1990); *Moodie v. Sch. Book Fairs, Inc.*, 889 F.2d 739 (7th Cir. 1989); *Devalk Lincoln Mercury, Inc. v. Ford Motor Co.*, 811 F.2d 326 (7th Cir. 1987); *First Class Coach & Equip., Inc. v. Thomas Built Buses, Inc.*, No. 6:05CV969ORL31JGG, 2006 WL 269983 (M.D. Fla. Feb. 3, 2006); *Travelodge Hotels, Inc. v. Elkins Motel Assocs., Inc.*, No. Civ. 03-799(WHW), 2005 WL 2656676 (D.N.J. Oct. 18, 2005); *Dalton v. Gen. Motors Corp.*, No. Civ. 05-727, 2005 WL 2654071, (D.N.J. Oct. 17, 2005); *McDonald's Corp. v. Magruder*, CIV-92-1643-PHX-RGS, Bus. Franchise Guide (CCH) ¶ 10,774 (D. Ariz. Sept. 28, 1995).

<sup>91</sup> See, e.g., *Ticknor v. Choice Hotels Int'l, Inc.*, 265 F.3d 931 (9th Cir. 2001) (Montana Law); *Barker v. Golf U.S.A., Inc.*, 154 F.3d 788, 791 (8th Cir. 1998).

<sup>92</sup> See, e.g., *Bondy's Ford, Inc. v. Sterling Truck Corp.*, 147 F. Supp. 2d 1283 (M.D. Ala. 2001).

termination without cause or termination at will;<sup>94</sup> dealer attendance requirements;<sup>95</sup> hour-of-operation requirements;<sup>96</sup> cancellation clauses;<sup>97</sup> covenants not to compete;<sup>98</sup> statutes of limitations on arbitration claims;<sup>99</sup> limitations on consequential damages;<sup>100</sup> transfer approval requirements;<sup>101</sup> the potential costs of arbitration;<sup>102</sup> and the size of the print on which the agreement was signed.<sup>103</sup> By and large, at least outside California, those challenges have rarely succeeded, leading to the observation that:

Anyone who has ever litigated a breach-of-contract case understands just how difficult it is to revoke a contract. Unconscionability sets an even higher standard. A lawyer can spend an entire career litigating contract disputes and never be successful in setting aside a contract, or any clause in it, on grounds of unconscionability.<sup>104</sup>

### **E. Some Previous Franchisee Successes**

On the other hand, courts have held contract provisions unconscionable where those provisions required the payment of unreasonably high liquidated damages on termination;<sup>105</sup>

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<sup>93</sup> See, e.g., *New S. Fed. Sav. Bank v. Anding*, 414 F. Supp. 2d 636 (S.D. Miss. 2005). Note that jury trial waivers may also be subject to constitutional constraints. See Edward Wood Dunham, *Enforcing Contract Terms Designed to Manage Franchisor Risk*, 19 FRANCHISE L.J. 91, 99 n.129 (Winter 2000). Mr. Dunham is Ms. Appleby's partner at Wiggins and Dana LLP.

<sup>94</sup> See, e.g., *Highway Equip. Co. v. Caterpillar Inc.*, 908 F.2d 60 (6th Cir. 1990); *Faltings v. Int'l Bus. Mach. Corp.*, 854 F.2d 1316 (Table), 1998 WL 83316 (4th Cir. Aug. 4, 1988); *KBQ, Inc. v. E.I. DuPont de Nemours & Co.*, 6 F. Supp. 2d 94 (D. Mass. 1998); *Jones Distrib. Co. v. White Consol. Indus., Inc.*, 943 F. Supp. 1445, 1462 (N.D. Iowa 1996); *Piantes v. Pepperidge Farm, Inc.*, 875 F. Supp. 929 (D. Mass. 1995); *Pennington's Inc. v. Brown-Forman Corp.*, 785 F. Supp. 1412 (D. Mont. 1991), *aff'd*, 2 F.3d 1157 (9th Cir. 1993); *Oreman Sales, Inc. v. Matsushita Elec. Corp. of Am.*, 768 F. Supp. 1174 (E.D. La. 1991); *Beitzell & Co. v. Brown-Forman Corp.*, CIV. No. 87-2, 1988 WL 66194 (D.D.C. June 17, 1988); *Blinn Wholesale Drug v. Eli Lilly & Co.*, 648 F. Supp. 1433 (E.D.N.Y. 1986); *Blalock Mach. & Equip. Co. v. Iowa Mfg. Co. of Cedar Rapids, Iowa*, 576 F. Supp. 774 (N.D. Ga. 1983); *RJM Sales & Mktg., Inc. v. Banfi Prods. Corp.*, 546 F. Supp. 1368 (D. Minn. 1982); *Consumer Int'l, Inc. v. SYSCO Corp.*, 951 P.2d 897 (Ariz. Ct. App. 1997) (termination at will requirement does not require that termination be for "good cause"); *Dorso Trailer Sales, Inc. v. Am. Body & Trailer, Inc.*, 372 N.W.2d 412 (Minn. Ct. App. 1985); *Smith v. Price Creameries*, 650 P.2d 825 (N.M. 1982).

<sup>95</sup> See, e.g., *Horcasitas v. Crown Cent. Petroleum Corp.*, 649 F. Supp. 1163 (D. Md. 1986).

<sup>96</sup> *Doebereiner v. Sohio Oil Co.*, 683 F. Supp. 791 (S.D. Fla. 1988), *aff'd*, 880 F.2d 329 (11th Cir. 1989), *amended by* 893 F.2d 1275 (11th Cir. 1990).

<sup>97</sup> See, e.g., *Seagram Distillers Co. v. Alcoholic Beverages Control Comm'n*, 519 N.E.2d 276 (Mass. 1988).

<sup>98</sup> *Boulangier v. Dunkin' Donuts Inc.*, 815 N.E.2d 572 (Mass. 2004), *cert. denied*, 544 U.S. 922 (2005); *Carvel Corp. v. Eisenberg*, No. 87 CIV. 608 (CSH), 1988 WL 120135 (S.D.N.Y. Oct. 31, 1988).

<sup>99</sup> See, e.g., *Snap-On Tools Corp. v. Scott*, No. 89-2121 C, Bus. Franchise Guide (CCH) ¶ 9,701 (E.D. Mo. July 16, 1990).

<sup>100</sup> See, e.g., *Golden v. Mobil Oil Corp.*, 882 F.2d 490 (11th Cir. 1989); *Adams v. John Deere Co.*, 774 P.2d 355 (Kan. Ct. App. 1989).

<sup>101</sup> *James v. Whirlpool Corp.*, 806 F. Supp. 835 (E.D. Mo. 1992).

<sup>102</sup> *English v. Cornwell Quality Tools Co.*, No. 22578, 2005 WL 3556281 (Ohio Ct. App. Dec. 30, 2005).

<sup>103</sup> See, e.g., *Mkt. Am., Inc. v. Tong*, No. 1:03CV00420, 2004 WL 1618574 (M.D.N.C. July 15, 2004); *Klosterman v. Choice Hotels Int'l, Inc.*, No. CIV-05-076-E-BLW, 2005 WL 1177947 (D. Idaho May 18, 2005).

<sup>104</sup> Kaufman, *supra* note 48, at 109 (2002).

<sup>105</sup> See, e.g., *Honey Dew Assocs., Inc. v. M & K Food Corp.*, 81 F. Supp. 2d 352 (D.R.I. 2000).

were unreasonably lopsided in favor of the franchisor upon termination;<sup>106</sup> held the franchisor harmless for its own negligence;<sup>107</sup> did not require any notice of contract violation or accord franchisees a reasonable opportunity to cure before termination;<sup>108</sup> allowed the franchisor to bring claims against franchisees in state or federal court, but forced franchisees to arbitrate their claims at the franchisor's headquarters;<sup>109</sup> were unjust with respect to forum selection;<sup>110</sup> contained damage limitations that could exclude damages for large breaches of contract;<sup>111</sup> awarded costs and fees to the prevailing party in a contract of adhesion;<sup>112</sup> permitted termination with only ten days notice and no opportunity to cure;<sup>113</sup> and permitted the franchisor to take the franchisee's property without compensation upon termination and to refuse to extend the franchise agreement beyond its original ten-year term without paying the franchisee for the fair market value of its business, even though the franchisee was prohibited from operating a restaurant in the same area.<sup>114</sup>

Franchisees have also had some success in establishing that the franchisor's conduct, rather than simply a contract provision itself, was unconscionable. Examples include a franchisor's agent's failure to read or explain to a "practically illiterate" franchisee an agreement that limited consequential damages,<sup>115</sup> a franchisor making substantial undisclosed "gouging" profits on sales to franchisees,<sup>116</sup> franchisor pre-contractual promises not to enforce a forum selection provision,<sup>117</sup> and where the franchisor's failure to provide an FTC-required written disclosure statement in a franchise sale constituted a "*per se* deceptive or unconscionable commercial act or practice."<sup>118</sup>

Moreover, franchisees have sometimes improved their chances for success by connecting the alleged unconscionability to a state Little FTC Act incorporating the

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<sup>106</sup> See, e.g., *Ashland Oil, Inc. v. Donohue*, 223 S.E.2d 433 (W. Va. 1976); *Shell Oil Co. v. Marinello*, 307 A.2d 598 (N.J. 1973).

<sup>107</sup> See, e.g., *Weaver v. Am. Oil Co.*, 276 N.E.2d 144 (Ind. 1971).

<sup>108</sup> See, e.g., *Payless Car Rental Sys., Inc., v. Draayer*, 716 P.2d 929 (Wash. Ct. App. 1986).

<sup>109</sup> See, e.g., *Ticknor v. Choice Hotels Int'l, Inc.*, 265 F.3d 931 (9th Cir. 2001).

<sup>110</sup> See, e.g., *Cutter v. Scott & Fetzer Co.*, 510 F. Supp. 905 (E.D. Wis. 1981) (Wisconsin law); *Kubis & Perszyk Assocs., Inc. v. Sun Microsystems, Inc.*, 680 A.2d 618 (N.J. 1996) (forum selection clauses in franchise agreements subject to the New Jersey Franchise Practices Act are presumptively invalid and, consistent with the Model Choice of Forum Act's prohibition against forum selection clauses obtained by "misrepresentation, duress, the abuse of economic power, or other unconscionable means," should not be enforced unless franchisor can satisfy the burden of proving such clause was not unfairly imposed on franchisee by means of franchisor's superior bargaining position).

<sup>111</sup> See, e.g., *Jacada Ltd. v. Int'l Mktg. Strategies*, 403 F.3d 701 (6th Cir. 2005), *cert. denied*, \_\_\_ U.S. \_\_\_, 126 S. Ct. 735 (2005).

<sup>112</sup> See, e.g., *Bob Schultz Motors, Inc. v. Kawasaki Motors Corp.*, 334 F.3d 721 (8th Cir. 2003).

<sup>113</sup> See, e.g., *Payless Car Rental Sys.*, 716 P.2d 929.

<sup>114</sup> See, e.g., *My Pie Int'l, Inc. v. Dowmont, Inc.*, Nos. 80 C 3309 & 80 C 4410, 1981 U.S. Dist. LEXIS 14649 (N.D. Ill. Aug. 21, 1981).

<sup>115</sup> See, e.g., *Johnson v. Mobil Oil Corp.*, 415 F. Supp. 264 (E.D. Mich. 1976).

<sup>116</sup> See, e.g., *In re DeRosa*, 98 B.R. 644 (Bankr. D.R.I. 1989).

<sup>117</sup> See, e.g., *Alphagraphics Franchising, Inc. v. Whaler Graphics, Inc.*, 850 F. Supp. 708 (D. Ariz. 1993).

<sup>118</sup> *Morgan v. Air Brook Limousine, Inc.*, 510 A.2d 1197, 1206 (N.J. Super. Ct. Law Div. 1986) (New Jersey Consumer Fraud Act).

unconscionability concept,<sup>119</sup> or claiming the loss of a statutory right,<sup>120</sup> rather than simply relying on a general notion of unfairness in the contract provisions or franchisor conduct.

In 2000, two experienced franchisee attorneys identified the typical provisions, or categories of provisions, that they believed were most objectionable to franchisees, including: (1) merger and integration clauses; (2) shortened statutes of limitation; (3) supplier control clauses; (4) loss of exclusive or protected territory clauses; (5) liquidated damage clauses; (6) future royalties clauses; (7) choice of law clauses; (8) restrictions on sales by the franchisee; (9) franchisor's limited obligations to the Franchisee; (10) claimed unfair dispute resolution clauses, ranging from jury trial waivers to unbalanced arbitration clauses. Other clauses that have been challenged as unfair, in the authors' experience, are: (11) rights of first refusal; (12) the requirement of signing a release in order to renew; (13) other terms of transfer or renewal; (14) provisions for termination without notice based on alleged multiple defaults under the franchise agreement, without requiring a showing of materiality or absence of cure; and (15) post-termination non-compete clauses.<sup>121</sup>

We invite debate as to whether some, all, or none of these types of clauses are vulnerable to an unconscionability challenge.

## V. THE RECENT CALIFORNIA ADR CASES

California codified the doctrine of unconscionability in 1979 with the enactment of Civil Code Section 1670.5, which is identical to UCC Section 2-302 (set forth above), except that Section 1670.5 applies to all contracts, not just those involving the sale of goods. As in other jurisdictions, the doctrine has been criticized as “‘chameleon-like’ because of its flexibility and insusceptibility to black-letter definition.”<sup>122</sup> As one California court recently noted, while the doctrine may be necessary as a “safety valve, . . . [it] creates the risk courts may intervene to deprive one contracting party of his or her bargain simply because the contractual obligations of the dissatisfied party prove more burdensome than originally anticipated.” Moreover, “[a]n undefined standard of what is ‘unfair’ fails to give businesses adequate guidelines as to what conduct may be challenged and thus enjoined and may sanction arbitrary or unpredictable decisions about what is fair or unfair.” From comments like these, it might be expected that application of the doctrine in California would be similar to other states, but as the Empirical Study observed, this has not been the case.<sup>123</sup>

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<sup>119</sup> See, e.g., *Knight v. Snap-On Tools Corp.*, 3 F.3d 1398 (10th Cir. 1993) (New Mexico Unfair Trade Practices Act); *Concorde Limousines, Inc. v. Moloney Coachbuilders, Inc.*, 835 F.2d 541 (5th Cir. 1987) (Texas Deceptive Trade Practices Act); *Morgan*, 510 A.2d at 1206 (New Jersey Consumer Fraud Act); *Century 21 Real Estate Corp. v. Hometown Real Estate Corp.*, 890 S.W.2d 118 (Tex. App. 1994) (Texas Deceptive Trade Practices Act).

<sup>120</sup> See *Kristian v. Comcast Corp.*, 446 F.3d 25 (1st Cir. 2006); *Perez v. Globe Airport Sec. Servs., Inc.*, 253 F.3d 1280, 1285-86 (11th Cir. 2001) (refusing to compel arbitration that required plaintiff to waive statutory rights for recovery of costs and fees under Title VII if she prevailed), *vacated per stipulation*, 294 F.3d 1275 (2002).

<sup>121</sup> Joseph A. Thomson and Robert Zarco, *And They Said the Titanic Wouldn't Sink: The Ten (Or So) Most Dangerous Contract Clauses*, in *SMOOTH SAILING AHEAD, AFA FRANCHISEE LEADERSHIP CONFERENCE* (2000).

<sup>122</sup> *Morris v. Redwood Empire Bancorp.*, 27 Cal. Rptr. 3d 797, 804 (Cal. Ct. App. 2005) (citation omitted).

<sup>123</sup> The Empirical Study found that in cases decided under U.C.C. Section 2-302, California (and New York) courts have been significantly more receptive to unconscionability arguments than have courts in other states. Absher, *supra* note 6, at 14-15. There is no comparable empirical data for cases decided under California Civil Code Section 1670.5.

**A. Bolter v. Superior Court (2001) -- a California Appellate Court Severs and Invalidates an Out-of-State Arbitration Forum Requirement**

In 2001, in *Bolter v. Superior Court*,<sup>124</sup> a California Appellate Court held that a contract provision requiring arbitration in Utah was unconscionable as applied to California franchisees. Three Chem-Dry carpet cleaning franchisees sued the franchisor in California alleging breach of the franchise agreements and the covenant of good faith and fair dealing. In response, the franchisor commenced an arbitration proceeding against the franchisees in Utah, and then moved in California state court to compel arbitration and dismiss the complaint. The trial court granted the franchisor's motion and the franchisees appealed, challenging the arbitration provisions as unconscionable.

The court's description of unconscionability in *Bolter* does not differ substantially from the formulations in other jurisdictions that have refused to find franchise agreement arbitration forum selection clauses to be unconscionable. For example, the court stated that California recognizes "both a procedural and substantive element, both of which must be present,"<sup>125</sup> takes into account the parties' relative bargaining strength, and requires finding "contract terms that are so one-sided as to 'shock the conscience,' or impose harsh or oppressive terms."<sup>126</sup>

The court concluded that the arbitration provisions were adhesive under the circumstances because: (1) the franchisor had not disputed the franchisees' claim that it was a "large[,] wealthy international franchisor"; (2) the franchisees were of "limited financial means" and operated "one-man" carpet-cleaning franchises; and perhaps most significantly (3) *during the renewal process*, the franchisees were presented with new forms of the franchise agreement which included the arbitration provision on a take it or leave it basis such that they "could not afford to dispute, much less attempt to negotiate, the place and manner" of the arbitration.<sup>127</sup>

After determining that the arbitration provision was adhesive, the court turned to the issue of fairness,<sup>128</sup> noting that, while adhesion contracts are not *per se* unconscionable, the party with superior bargaining power may not draft a contract giving itself an undue advantage.<sup>129</sup> The court focused on the "place and manner" of the arbitration provision (*e.g.*, the requirement that the franchisees arbitrate their claims in Utah) and evaluated the parties' relative abilities to litigate in an out-of-state forum. Accepting the franchisees' claims that they operated "mom and pop" businesses that required their daily presence, the court concluded that it was neither reasonable nor affordable for the franchisees to pursue their claims in arbitration in Utah and determined that the provision was unconscionable.<sup>130</sup> The court's holding was also

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<sup>124</sup> 104 Cal. Rptr. 2d 888 (Cal. Ct. App. 2001).

<sup>125</sup> Both elements need not be present to the same degree. "The more substantively oppressive the contract term, the less evidence of procedural unconscionability is required to come to the conclusion that the term is unenforceable, and vice versa." *Id.* at 893 (quoting *Armendariz v. Found. Health Psychcare Servs., Inc.*, 6 P.3d 669 (Cal. 2000)). Additionally, a "claim of unconscionability often cannot be determined merely by examining the face of a contract, but will require inquiry into its [commercial] setting, purpose, and effect." *Id.* (internal citation and quotation marks omitted).

<sup>126</sup> *Id.*

<sup>127</sup> *Id.*

<sup>128</sup> *Id.* at 893-94.

<sup>129</sup> *Id.*

<sup>130</sup> *Id.*

influenced, at least in part, by the fact that when the franchisees first purchased their businesses, the franchisor had been based in California and the agreements did not include an arbitration provision. Thus, the franchisees “never anticipated [the franchisor] would relocate its headquarters to Utah and mandate that all disputes be [resolved in an arbitration] there.”<sup>131</sup>

Because it found only the requirement that arbitration take place in Utah unconscionable, rather than the requirement of arbitration itself, the court simply struck that provision and otherwise upheld the parties’ agreement to submit disputes to arbitration.<sup>132</sup>

**B. Ticknor v. Choice Hotels International, Inc. (2001) -- the Ninth Circuit Invalidates a Maryland Forum Selection Clause**

In the same year as the *Bolter* decision, in *Ticknor v. Choice Hotels International, Inc.*, the Ninth Circuit invalidated a Maryland arbitral forum selection clause as unconscionable under Montana law when applied to Montana franchisees.<sup>133</sup> Plaintiffs were franchisees of Choice Hotels International (“Choice Hotels”) who operated an Econo-Lodge in Montana. In the words of the Ninth Circuit, the “ink was hardly dry” on the franchise agreement when disputes arose. The franchisees stopped paying their royalty fees and, predictably, Choice Motels terminated the franchise agreement. In accordance with the terms of the franchise agreement, Choice Motels filed a demand for arbitration in Maryland with the AAA. In response, the franchisees filed a state court suit in Montana to enjoin the arbitration and, after removal, the case reached the Ninth Circuit.

**1. The Ticknor Majority Opinion**

The *Ticknor* majority applied an unconscionability analysis similar to that in *Bolter*.<sup>134</sup> First, the majority quickly concluded that the franchise agreement was a contract of adhesion because it was “a standardized, form agreement” that the franchisees were “forced to accept or reject without negotiation.”<sup>135</sup> The court held that because it was in an adhesion contract, “the

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<sup>131</sup> *Id.* at 894.

<sup>132</sup> The court also examined the provisions in the agreement which precluded consolidating claims and exemplary/punitive damages, and found that this preclusion had “no justification other than as a means of maximizing an advantage over” the franchisees. *Id.* at 909. The court further found that the franchisor arguably “understood those terms would effectively preclude its franchisees from ever raising any claims against it, knowing the increased costs and burdens on their small businesses would be prohibitive.” *Id.* at 895. Note, however, that the court did not actually hold that these provisions were unconscionable. Instead, the court seems to have expressed its opinion regarding these provisions simply to bolster its holding that the requirement that the arbitration occur in Utah was unconscionable under the circumstances.

With the benefit of hindsight, it is clear that the court’s pointed comments regarding the provision precluding the consolidation of claims was a harbinger of decisions to come regarding the unconscionability of such provisions. See, e.g., *Am. Online, Inc. v. Super. Ct.*, 108 Cal. Rptr. 2d 699, 712 (Cal. Ct. App. 2001) *Szetela v. Discover Bank*, 118 Cal. Rptr. 2d 862, 867-68 (Cal. Ct. App. 2002); *Ting v. AT&T*, 319 F.3d 1126, 1150 (9th Cir. 2003); *Discover Bank v. Super. Ct.*, 113 P.3d 1100 (Cal. 2005).

<sup>133</sup> 265 F.3d 931 (9th Cir. 2001).

<sup>134</sup> First addressing procedural issues, the court determined that the Federal Arbitration Act, 9 U.S.C. § 1 *et seq.*, did not preempt state law principles regarding the validity and enforceability of a contract (including the doctrine of unconscionability), and that Montana Law (rather than Maryland law as required by franchise agreement) applied. *Ticknor*, 265 F.3d at 937-39.

<sup>135</sup> *Id.* at 939-40. The court’s finding that the franchise agreement was an adhesion contract was made without reference to the United States Supreme Court’s decision in *Prima Paint Corp. v. Flood & Conklin Mfg. Co.*, 388 U.S. 395 (1967), holding that only challenges to an arbitration provision are to be resolved by a court, and that all questions regarding the validity of the contract are for the arbitrator to resolve. The Supreme Court recently revisited

provision will not be enforced against the weaker contracting party if it is (1) not within that party's reasonable expectations, or (2) if within those expectations, it is unduly oppressive, unconscionable, or against public policy."<sup>136</sup> The court then concluded that the arbitration provision was unconscionable under Montana law because it was "one-sided" in that franchisees were required to pursue all of their claims in arbitration while Choice Motels was free to pursue claims for indemnity, trademark infringement and to collect monies owed under the franchise agreement in state or federal court.<sup>137</sup> It does not appear that the court considered whether it would have been possible to sever portions of the arbitration provisions -- e.g., striking the requirement in the agreement that the arbitration occur in Maryland.

## 2. The Ticknor Dissent

Judge Tashima dissented, based on many of the grounds that a franchisor would likely raise.<sup>138</sup> Judge Tashima did not agree that the franchise agreement was adhesive because, in his view, the franchisees were not unsophisticated parties, there was no evidence that the franchisees lacked meaningful alternatives (*i.e.*, that they could not have entered into an agreement with a different hotel franchisor), and the parties negotiated the transaction.<sup>139</sup> Judge Tashima was particularly troubled by the majority's finding of adhesion, which he viewed as leading to the inevitable conclusion that "every form contract between parties of even slightly unequal bargaining power is a contract of adhesion -- and thus is prone to invalidation."<sup>140</sup>

The dissent concluded that while the arbitration provision was not entirely mutual, it was not so one-sided as to be unconscionable. There were three types of claims that Choice Motels had the right to pursue in state or federal court: (1) indemnification claims; (2) trademark infringement; and (3) money owed under the franchise agreement. Each of these claims could run in only one direction (franchisor against franchisee), as the franchisees did not have any indemnification rights, did not have trademarks to protect, and did not receive payments under the franchise agreement. Moreover, as Judge Tashima noted, claims for indemnification typically arise in connection with third-party claims that are already being litigated. With respect to trademark claims, Judge Tashima observed that the "classic remedy" for infringement is a federal court injunction and that an arbitrator has no power to enforce such an injunction. As a result, Judge Tashima believed that it was irrelevant that Choice Motels was not required to arbitrate these types of claims.<sup>141</sup>

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this general proposition in *Buckeye Check Cashing, Inc. v. Cardegna*, 126 S. Ct. 1204 (2006), in which it held that whether a contract is void on the ground of illegality was a question for the arbitrator.

<sup>136</sup> *Ticknor*, 265 F.3d at 939.

<sup>137</sup> Significantly, the court rejected Choice's argument that Montana law limited the application of the doctrine of unconscionability to consumer contracts where there is an obvious disparity of bargaining power and should not apply to general commercial transactions between "sophisticated" parties. *Id.* at 941.

<sup>138</sup> Interestingly, Judge Tashima had written the Ninth Circuit's opinion in *Ting v. AT&T*, 319 F.3d 1126 (9th Cir. 2003), in which the court found that a class action waiver, fee-splitting and other provisions in AT&T's customer agreement were unconscionable.

<sup>139</sup> *Ticknor*, 265 F.3d at 942-43 (Tashima, J., dissenting).

<sup>140</sup> *Id.* at 943 n.5.

<sup>141</sup> *Id.* at 943-44 (Tashima, J., dissenting).

**C. Independent Association of Mailbox Center Owners v. Superior Court (2005) -- a California Appellate Court Finds a Ban on Group Arbitration and Arbitration Damage Limitations Unconscionable**

In 2005, the Fourth District of the California Court of Appeal -- the same court that had issued *Bolter* -- decided *Independent Association of Mailbox Center Owners v. Superior Court*, and held, among other things, that a ban on group arbitrations and certain damage limitations were unconscionable.<sup>142</sup> The case is both factually and procedurally convoluted. Numerous franchisees and their independent association filed a state court lawsuit against Mailboxes, Etc. USA ("MBE"), asserting various common law and statutory claims based on the conversion of their stores to the UPS Store format. All of the franchise agreements (1) required that the franchisees pursue any claims in arbitration, while MBE (like Choice Motels in *Ticknor*), had the right to proceed in court to seek certain relief; and (2) limited the damages that could be recovered, as well as the availability of other remedies. Some, but not all, of the franchise agreements also precluded class-wide arbitrations.

MBE moved to compel arbitration of the franchisees' claims in individual proceedings. In their opposition, the franchisees sought a ruling shifting the costs of arbitrating their statutory claims to MBE.<sup>143</sup> The trial court granted MBE's request to compel the individual arbitrations, refused to re-allocate the costs of arbitration and referred the latter issue to the arbitrator to decide.

Following the trial court's rulings, the franchisees initiated two arbitrations -- one with the AAA, the other with JAMS. Both the AAA and JAMS refused to proceed with group arbitrations. In response, the franchisees moved in the trial court to consolidate the arbitrations. The trial court denied the motion. The franchisees filed a writ petition challenging the denial of their consolidation motion and the trial court's refusal to shift arbitration costs to MBE. The franchisees also challenged the franchise agreement provisions limiting damages, and the arbitration clause's lack of mutuality, which allowed MBE to pursue various claims in court.

On appeal, the court cited *Bolter* for the California law of unconscionability.<sup>144</sup> The court then observed that other courts have found that franchise agreements "can have some characteristics of contracts of adhesion" and that there is frequently a disparity of bargaining power between franchisors and franchisees.<sup>145</sup> The court held that the actual terms of the franchise agreement needed to be considered to "see if the characteristics of unconscionability are present in part or whole."<sup>146</sup> Put another way, the *Mailbox Owners* court appeared to find

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<sup>142</sup> 34 Cal. Rptr. 3d 659 (Cal. Ct. App. 2005) (hereinafter *Mailbox Owners*).

<sup>143</sup> The franchisees relied upon a previous decision of the California Supreme Court, *Armendariz v. Found. Psychcare Servs., Inc.*, 6 P.3d 669, 689 (Cal. 2000), for this claim.

<sup>144</sup> *Mailbox Owners*, *supra* note 142, at 668 (citing *Bolter v. Super. Ct.*, 104 Cal. Rptr. 2d 888 (Cal. Ct. App. 2001)). Preliminarily, the court considered whether a decision regarding the propriety of a class-wide arbitration waiver was the sort of "gateway" matter that should be decided by a court rather than the arbitrator. This question was governed by the United States Supreme Court's holding in *Green Tree Fin. Corp. v. Bazzle*, 539 U.S. 444 (2003), and the California Supreme Court's pronouncement in *Discover Bank v. Superior Court*, 113 P.3d 1100 (Cal. 2005), that whether an arbitration agreement or portions thereof are unconscionable or contrary to public policy is a decision for a court. The court answered this question affirmatively, holding that questions regarding "the validity and binding nature of the given arbitration clauses[] under the theory of unconscionability" were gateway matters to be decided by the courts. *Mailbox Owners*, *supra* note 142, at 667-69.

<sup>145</sup> *Id.* (citations omitted).

<sup>146</sup> *Id.* at 668. The court also concluded that franchise agreements "resemble employment agreements to the extent that the franchisees' livelihoods are involved." *Id.* at 670.

procedural unconscionability based on the holdings *in other cases* that franchise agreements are adhesive, and then turned to the question of substantive unconscionability.

Turning to the specific MBE franchise agreements, the court:

- Held that the ban on group arbitrations was unconscionable;<sup>147</sup>
- Rejected the trial court's findings and concluded that the franchisees had adequately established that there were common issues of law and fact and that "group arbitration would be a preferred means of dispute resolution";<sup>148</sup> and
- Held that the provisions in the franchise agreements precluding the arbitrator from awarding punitive damages, consequential and other forms of damages (and in some instances, attorneys' fees and costs) were unconscionable to the extent that they deprived the franchisees of "statutorily authorized remedies" and ordered the trial court to strike them.<sup>149</sup>

The court also considered whether the franchise agreement provisions requiring the parties to split arbitration costs were unconscionable insofar as they applied to claims that were "carefully tethered to statutory or constitutional provisions" (rather than common law claims) and "involve[d] substantive and procedural rights not just for the benefit of individuals but also for public purposes."<sup>150</sup> On this last issue, the court observed "that the franchise factual context is sufficiently similar to mandatory employer/employee arbitration [and] consumer arbitration" to apply the principles articulated in employment and consumer cases. Accordingly, the appellate court concluded that the franchisees had made a "*prima facie* showing" that at least some of their statutory claims "affect the public interest," appeared to fall within applicable precedent, and were of the type that should be entitled to an advance ruling by the court as to whether the cost provision in the arbitration clause should be severed before the arbitration took place.<sup>151</sup> The court further found that it was for the trial court, not the arbitrator, to decide the cost allocation issues and that the franchisees would need to establish that the arbitration fees would be "unaffordable" so as to warrant severing the cost sharing provision.<sup>152</sup>

Underlying the court's analysis, as noted above, was the apparent assumption that franchisees are analogous to consumers and employees, categories of litigants often accorded special protection under the law. The court relied heavily on *Szetela v. Discover Bank*,<sup>153</sup> in which a California Appellate Court held unconscionable a credit card company's attempt to

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<sup>147</sup> *Id.* (citing and relying on *Discover Bank*, 113 P.3d 1100, for the former holding, and *Green Tree Financial*, 539 U.S. 444, for the later holding).

<sup>148</sup> *Id.* at 671.

<sup>149</sup> *Id.* at 672. The franchisees were pursuing a number of claims that the court later determined to be "statutory" within the rules of *Armendariz v. Foundation Psychcare Services, Inc.*, 6 P.3d 669 (Cal. 2000), including alleged violations of the California Franchise Investment Law (Cal. Corp. Code § 31000 *et seq.*), the Cartwright Act (Cal. Bus. & Prof. Code § 16700 *et seq.*), the Uniform Trade Secrets Act (Cal. Civ. Code § 3426 *et seq.*) and the Unfair Competition Law (Cal. Bus. & Prof. Code § 17200 *et seq.*).

<sup>150</sup> *Mailbox Owners*, *supra* note 142, at 674.

<sup>151</sup> *Id.* at 675 (citing *Armendariz*, 6 P.3d 669; *Boghos v. Certain Underwriters at Lloyd's of London*, 115 P.3d 68 (Cal. 2005)).

<sup>152</sup> *Id.* at 676.

<sup>153</sup> 118 Cal. Rptr. 2d 862 (Cal. Ct. App. 2002).

preclude, in terms printed on a “bill stuffer,” class arbitration of small individual consumer claims that would likely never be pursued individually. Without this underlying assumption, it may have been difficult for the court to reach the same conclusion. Courts in other jurisdictions have emphasized the commercial nature of the franchise relationship and have often refused to apply consumer protections to franchisees.<sup>154</sup> On unconscionability claims, courts’ characterizations of the franchise relationship, and particular franchisees, can be outcome-determinative.<sup>155</sup>

**D. *Nagrampa v. Mailcoups, Inc. (2005) -- a Related Decision from the Ninth Circuit***

In March 2005, in *Nagrampa v. Mailcoups, Inc.*, the Ninth Circuit rejected a franchisee’s argument that an arbitration provision was unconscionable because it was essentially buried in the franchise agreement.<sup>156</sup> Two months later, however, the Ninth Circuit vacated the panel’s opinion and granted an en banc rehearing, which had yet to occur when this paper went to press. In *Nagrampa*, the franchise agreement contained a comprehensive, mutual arbitration clause covering any claims arising out of the agreement. A dispute arose and Nagrampa, the franchisee, filed suit, arguing primarily that the arbitration provision was unconscionable because it was contained within a franchise agreement that she claimed was adhesive.

Based on the United States Supreme Court’s decision in *Prima Paint Corp. v. Flood & Conklin Manufacturing Co.*<sup>157</sup> the court concluded that the validity and enforceability of the franchise agreement as a whole were for the arbitrator to resolve and that the judicial inquiry was limited to the validity of the arbitration provision.<sup>158</sup> Having thus narrowed the issues, the court made quick work of Nagrampa’s claim that the arbitration provision was procedurally unconscionable because it was found on the twenty-fifth page of the thirty page franchise agreement and she had not been specifically advised about the provision or the cost of arbitration. The panel was not impressed with this argument, citing California law that a party cannot use “his own lack of diligence [in failing to read an agreement] to avoid arbitration”<sup>159</sup> and noting that the franchisee was an experienced business person who “had ample opportunity to read the arbitration clause and to consider its implication.”<sup>160</sup> The court therefore determined that the provision was not procedurally unconscionable and rejected the franchisee’s claims, without addressing substantive unconscionability. Of course, whether the en banc court will adopt the panel’s opinion remains to be seen. The court’s characterization of the franchisee as a business person, rather than a consumer, however, differs from the California Appellate Court’s characterization in *Mailbox Owners*.

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<sup>154</sup> See, e.g., *We Care Hair Dev., Inc. v. Engen*, 180 F.3d 838, 843 (7th Cir. 1999). Ms. Appleby’s law firm represented We Care Hair Development, Inc. in this case.

<sup>155</sup> See discussion *infra* Section VI.C.3.

<sup>156</sup> 401 F.3d 1024 (9th Cir. 2005), *hearing en banc granted by* 413 F.3d 1024 (9th Cir. 2005).

<sup>157</sup> 388 U.S. 395 (1967).

<sup>158</sup> *Nagrampa*, 401 F.3d at 1027-28. The court distinguished its decision in *Ticknor v. Choice Hotels International, Inc.*, 265 F.3d 931 (9th Cir. 2001), in which it had held that an arbitration clause in a franchise agreement was unconscionable because the agreement as a whole was adhesive on the grounds that it had not considered the holding in *Prima Paint*, 388 U.S. 395.

<sup>159</sup> *Nagrampa*, 401 F.3d at 1029-30 (citations omitted).

<sup>160</sup> *Id.*

## E. Is California Law Settled?

Before addressing whether cases such as *Bolter* and *Mailbox Owners* will breathe new life into the unconscionability doctrine in franchising across the country, it is fair to ask how these cases compare with other unconscionability cases in California. As discussed below, California courts have not been consistent in their unconscionability analyses, and further clarification from the California Supreme Court may be warranted.<sup>161</sup>

### 1. Conflicting Standards for Determining “Procedural Unconscionability”

While the *Bolter* and *Mailbox Owners* courts acknowledged the need to consider procedural unconscionability, the actual analysis of that issue was limited to whether the contract or arbitration provision was adhesive (*i.e.* “a standard-form contract, drafted by the party with superior bargaining power, which relegates to the other party the option of either adhering to its terms without modification or rejecting the contract entirely.”<sup>162</sup> Once the courts made the finding of adhesion, they turned to the question of substantive unconscionability.

The *Bolter* and *Mailbox Owners* courts are not alone in equating a finding of adhesion with a finding of procedural unconscionability. Other courts applying California law have found that an adhesion contract or a contract that is presented to a party on a “take it or leave it basis” is *ipso facto* procedurally unconscionable. For example, in a case involving senior citizens who obtained reverse mortgages from a lender, a California Court of Appeal held that “[a] finding of a contract of adhesion is *essentially* a finding of procedural unconscionability.”<sup>163</sup> Later federal cases applying California law have gone one step further and concluded that an adhesion contract is *necessarily* procedurally unconscionable.<sup>164</sup> Similarly, in 2005, a California appellate court held that a DSL service agreement provided to a party on a take-it or leave-it basis without an opportunity for negotiation or to opt out is “quintessential procedural unconscionability.”<sup>165</sup>

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<sup>161</sup> As early as 1985, in *Perdue v. Crocker National Bank*, 702 P.2d 503, 511 n.9 (Cal. 1985), the California Supreme Court found that there were two “pathways” to defining unconscionability in the California cases, but at that time, the court predicted that both “pathways” should lead to the same result. As of the 1980’s, the first “pathway” was the approach that *Bolter* explicitly followed: the court will first consider whether an allegedly unconscionable contract or provision is one of adhesion; and then, if the answer is yes, the court must then determine whether (1) the contract or term was beyond the “reasonable expectations of the weaker party,” or (2) was “unduly oppressive or unconscionable.” See *Graham v. Scissor-Tail, Inc.*, 623 P.2d 165 (Cal. 1981) (recognizing this “pathway”). The second “pathway” was the two-step substantive/procedural analysis. See *A & M Produce Co. v. FMC Corp.*, 186 Cal. Rptr. 114, 121-22 (Cal. Ct. App. 1982) (first applying this approach); *Armendariz v. Found. Health Psychcare Servs., Inc.*, 6 P.3d 669, 689-90 (Cal. 2000); (*Discover Bank v. Super. Ct.*, 113 P.3d 1100, 1108 (Cal. 2005) (citing *Little v. Auto Stiegler, Inc.*, 63 P.3d 979, 983 (Cal. 2003) and applying the procedural/substantive test in assessing the unconscionability of various provisions within a credit card agreement).

<sup>162</sup> *Circuit City Stores, Inc. v. Adams*, 279 F.3d 889, 893 (9th Cir. 2002) (citations omitted) (hereinafter *Adams*), *cert. denied*, 535 U.S. 1112.

<sup>163</sup> *Flores v. Transamerica HomeFirst, Inc.*, 113 Cal. Rptr. 2d 376, 381 (Cal. Ct. App. 2001) (emphasis added).

<sup>164</sup> See, e.g., *Adams, supra* note 162, at 893 (finding that the agreement “is procedurally unconscionable because it is a contract of adhesion . . . .”); *ACORN v. Household Int’l, Inc.*, 211 F. Supp. 2d 1160, 1168 (N.D. Cal. 2002) (“[a] contract or clause is procedurally unconscionable if it is a contract of adhesion”).

<sup>165</sup> *Aral v. Earthlink, Inc.*, 36 Cal. Rptr. 3d 299, 238 (Cal. Ct. App. 2005); see also *Discover Bank*, 113 P.3d at 1108 (finding procedural unconscionability when credit card customers had to either sign an amendment requiring arbitration or close their accounts); *Szetela v. Discover Bank*, 118 Cal. Rptr. 2d 862, 867-68 (Cal. Ct. App. 2002) (credit card agreement; “[w]hen the weaker party is presented the clause and told to ‘take it or leave it’ without the opportunity for meaningful negotiation, oppression, and therefore procedural unconscionability, are present”).

However, other courts applying California law have looked beyond these factors and also required a showing of oppression or surprise before finding procedural unconscionability, leading the authors to conclude that this particular issue needs to be resolved by the California Supreme Court. For example, a 2005 state appellate case, *Morris v. Redwood Empire Bancorp*,<sup>166</sup> carefully considered whether a contract of adhesion was *necessarily* procedurally unconscionable, concluded otherwise, and offered the following criticism:

[C]ourts often reflexively conclude the finding of an adhesion contract alone satisfies the procedural prong, and immediately move on to the subject of substantive unconscionability . . . . Consequently, other procedural issues, including surprise, often are ignored when balancing or weighing procedural and substantive unconscionability. Undue reliance on any one procedural factor to the exclusion of others may produce analytical myopia and obscure the larger unconscionable picture.<sup>167</sup>

The *Morris* court continued: “[t]o speak in terms of ‘procedural unconscionability’ is to elevate the fact of adhesiveness, which is not *per se* oppressive, to the same level as substantive unconscionability, thus tending to obscure the real issue.”<sup>168</sup> While ultimately finding that the form merchant account agreement in question was adhesive, the appellate court stated that this only “herald[ed] the beginning, not the end, of our inquiry into its enforceability.”<sup>169</sup>

Clearly, whether “procedural unconscionability” requires more than a finding of adhesion is, at least potentially, outcome-determinative in California, and the eventual resolution of this issue will have significant implications in franchising -- given that franchise agreements are frequently characterized as contracts of adhesion, or having at least some elements of adhesiveness.<sup>170</sup>

#### **a. Conflicting Standards for “Oppression”**

There is further confusion in California regarding the standards for finding oppression. “Commonly, oppression arises from an inequality of bargaining power that results in no real negotiation and the absence of meaningful choice.”<sup>171</sup> However, what constitutes “meaningful choice” -- and how much choice is necessary -- is far from clear. As discussed in Section VI.B., this particular debate may also have serious ramifications for the doctrine of unconscionability in franchising.

Some California courts have concluded that the evidence of choice -- *i.e.*, that other vendors or employers may not require the offending provision -- is not dispositive, or is even

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<sup>166</sup> 27 Cal. Rptr. 3d 797 (Cal. Ct. App. 2005).

<sup>167</sup> *Id.* at 806.

<sup>168</sup> *Id.* (citations omitted).

<sup>169</sup> *Id.* at 807.

<sup>170</sup> See, e.g., *Keating v. Super. Ct.*, 645 P.2d 1192, 1209-10 (Cal. 1982), *overruled on other grounds by Southland Corp. v. Keating*, 465 U.S. 1 (1984); *Postal Instant Press, Inc. v. Sealy*, 51 Cal. Rptr. 2d 365, 373-74 (Cal. Ct. App. 1996); see also *E.S. Bills, Inc. v. Tzucanow*, 700 P.2d 1280, 1287-88 (Cal. 1985) (Mosk, J., concurring).

<sup>171</sup> *Stirlen v. Supercuts, Inc.*, 60 Cal. Rptr. 2d 138, 145 (Cal. Ct. App. 1997) (citations omitted).

irrelevant.<sup>172</sup> However, the *Morris* court held that “[o]ppression refers not only to an absence of power to negotiate the terms of the contract, *but also to the absence of reasonable market alternatives.*”<sup>173</sup> For example, “in many cases of adhesion contracts, the weaker party lacks not only the opportunity to bargain but also any realistic opportunity to look elsewhere for a more favorable contract; he must either adhere to the standardized agreement or forego the *needed* service.”<sup>174</sup> In another formulation of this position, a different California appellate court held in 1989 that the oppression factor “may be defeated, if the complaining party has a meaningful choice of reasonably available alternative sources of supply from which to obtain the *desired* goods and services free of the terms claimed to be unconscionable.”<sup>175</sup>

**b. Conflicting Standards in Requiring “Surprise”**

“Surprise” has been defined as the “extent to which the terms of the bargain are hidden in a ‘prolix printed form’ drafted by a party in a superior bargaining position.”<sup>176</sup> The appellate court in *Morris*, observed that “unfortunately, [procedural surprise] has been given short shrift by several courts analyzing unconscionability.”<sup>177</sup> As if to illustrate this very point, yet another California appellate court held in 2004 that “[w]here an adhesive contract is oppressive, surprise need not be shown.”<sup>178</sup>

**c. Is the Relative Sophistication of the Party Relevant?**

Some California courts hold that it is “reasonable to expect even an unsophisticated businessman to carefully read, understand, and consider all the terms of the agreement affecting . . . his business.”<sup>179</sup> Other courts find that “experienced but legally unsophisticated businessmen may be unfairly surprised by unconscionable contract terms.”<sup>180</sup>

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<sup>172</sup> See, e.g., *Szetela v. Discover Bank*, 118 Cal. Rptr. 2d 862, 867-68 (Cal. Ct. App. 2002) (the availability of substitute goods is not “the relevant test for unconscionability . . . and whether the consumer could have found another credit card issuer who would not have required his acceptance of a similar clause is not the deciding factor”); *Villa Milano Homeowners Ass’n v. Il Davorge*, 102 Cal. Rptr. 2d 1, 5 (Cal. Ct. App. 2000) (rejecting defendant developer’s argument that arbitration agreement was not adhesive because plaintiffs could have purchased property elsewhere; “a contract might be adhesive even if the weaker party could reject the terms and go elsewhere”); *Ingle v. Circuit City Stores Inc.*, 328 F.3d 1165, 1172 (9th Cir. 2003) (finding employment contract procedurally unconscionable and holding that the “availability of other options does not bear on whether a contract is unconscionable. Rather, when a party who enjoys greater bargaining power than another party presents the weaker party with a contract without meaningful opportunity to negotiate,” procedural unconscionability is present) (hereinafter *Ingle*), *cert. denied*, 540 U.S. 1160 (2004), *holding upheld* by 408 F.3d 592 (9th Cir. 2005).

<sup>173</sup> *Morris v. Redwood Empire Bancorp*, 27 Cal. Rptr. 3d 797, 807 (Cal. Ct. App. 2005) (emphasis added). The court in *Morris* noted, however, that “not every opportunity to seek an alternative . . . is ‘realistic.’” *Id.*

<sup>174</sup> *Id.* (citing *Madden v. Kaiser Found. Hosps.*, 552 P.2d 1178, 1185 (Cal. 1976)) (emphasis added).

<sup>175</sup> *Dean Witter Reynolds, Inc. v. Super. Ct.*, 259 Cal. Rptr. 789, 795 (Cal. Ct. App. 1989).

<sup>176</sup> *Crippen v. Cent. Valley RV Outlet, Inc.*, 22 Cal. Rptr. 3d 189, 193 (Cal. Ct. App. 2004).

<sup>177</sup> *Morris*, 27 Cal. Rptr. 3d at 808.

<sup>178</sup> *Abramson v. Juniper Networks, Inc.*, 9 Cal. Rptr. 3d 422, 436 (Cal. Ct. App. 2004).

<sup>179</sup> *Morris v. Redwood Empire Bancorp*, 27 Cal. Rptr. 3d 797, 809 (Cal. Ct. App. 2005).

<sup>180</sup> *ABF Capital Corp. v. Grove Props. Co.*, 23 Cal. Rptr. 3d 803, 811 (Cal. Ct. App. 2005) (citation and quotation marks omitted).

## 2. Substantive Unconscionability

Substantive unconscionability in California is “less easily explained” than procedural unconscionability, but courts generally hold that it turns on whether the contract terms are “one-sided” and “shock the conscience.” While general contract principles normally leave parties free to accept asymmetrical terms, the “doctrine of unconscionability limits the extent to which a stronger party may, through a contract of adhesion, impose the arbitration forum on the weaker party without accepting that forum for itself.” Thus, substantive unconscionability is established when the agreement lacks at least a “modicum of bilaterality.”<sup>181</sup>

### a. Lack of Mutuality

An example of the extent to which California law appears unsettled is the question of whether lack of mutuality is sufficient to establish substantive unconscionability.<sup>182</sup> As noted above, the California Supreme Court in *Armendariz* declined to hold that “all lack of mutuality in a contract of adhesion was invalid,” but rather concluded that fairness and mutuality require each side to arbitrate all claims “arising out of the same transaction or occurrence or series of transactions or occurrences.”<sup>183</sup>

Not all courts have followed *Armendariz*. In a 2002 case from the United States District Court for the Central District of California,<sup>184</sup> the court found that a non-mutual arbitration agreement was not unconscionable. This arbitration agreement required consumers to arbitrate nearly all disputes with DirecTV, yet allowed DirecTV to litigate select claims against its consumers. The court found that this lack of mutuality was not unconscionable because (1) general principles of contract law maintain that non-mutual contracts are not unconscionable “so long as there is some consideration on both sides,” and (2) a contrary rule would

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<sup>181</sup> *Armendariz v. Found. Health Psychcare Servs., Inc.*, 6 P.3d 669, 691-92 (Cal. 2000).

<sup>182</sup> The argument that a lack of mutuality can invalidate a franchise agreement’s arbitration provision is essentially a “dead letter” in some jurisdictions. See *Doctor’s Assocs., Inc. v. Distajo*, 66 F.3d 438, 451-53 (2d Cir. 1995) (surveying cases and rejecting mutuality defense under Connecticut law, reasoning that “where the agreement to arbitrate is integrated into a larger unitary contract, the consideration for the contract as a whole covers the arbitration clause as well”; citing RESTATEMENT (SECOND) OF CONTRACTS § 79 (1979) and noting that mutuality arguments are “largely dead letters”), *aff’d on subsequent appeal*, 107 F.3d 126, 135 (2d Cir. 1996); see also *Harris v. Green Tree Fin. Corp.*, 183 F.3d 173, 180 (3d Cir. 1999) (rejecting mutuality defense under Pennsylvania law); *Barker v. Golf U.S.A., Inc.*, 154 F.3d 788, 792 (8th Cir. 1998) (“[U]nder Oklahoma law, mutuality of obligation is not required for arbitration clauses so long as the contract as a whole is supported by consideration”); *Doctor’s Assocs., Inc. v. Jabush*, 89 F.3d 109, 112-13 (2d Cir. 1996) (rejecting claim that Subway arbitration clause was unenforceable contract of adhesion that lacked mutuality); *Doctor’s Assocs., Inc. v. Stuart*, 85 F.3d 975, 980-81 (2d Cir. 1996) (same); *Wilson Elec. Contractors, Inc. v. Minnotte Contracting Corp.*, 878 F.2d 167, 168 (6th Cir. 1989); *Becker Autoradio U.S.A., Inc. v. Becker Autoradiowerk GmbH*, 585 F.2d 39, 47 (3d Cir. 1978); *Design Benefit Plans, Inc. v. Enright*, 940 F. Supp. 200, 205 (N.D. Ill. 1996) (rejecting mutuality claim under Illinois law where contract as a whole was supported by consideration); *W.L. Jordan & Co. v. Blythe Indus.*, 702 F. Supp. 282, 284 (N.D. Ga. 1988); *Willis Flooring, Inc. v. Howard S. Lease Constr. Co. & Assocs.*, 656 P.2d 1184, 1185 (Alaska 1983); *LaBonte Precision, Inc. v. LPI Indus. Corp.*, 507 So.2d 1202, 1203 (Fla. Dist. Ct. App. 1987); *Kalman Floor Co. v. Jos. L. Muscarelle, Inc.*, 481 A.2d 553 (N.J. Super. Ct. App. Div. 1984), *aff’d*, 486 A.2d 334 (N.J. 1985); *Sablosky v. Edward S. Gordon Co.*, 535 N.E.2d 643, 646 (N.Y. 1989). *Contra* *Ticknor v. Choice Hotels Int’l, Inc.*, 265 F.3d 931 (9th Cir. 2001) (invalidating arbitration agreement under Montana law for lack of mutuality), *cert. denied*, 534 U.S. 1133 (2002); *Stevens/Leinweber/Sullens, Inc. v. Holm Dev. & Mgmt., Inc.*, 795 P.2d 1308, 1313 (Ariz. Ct. App. 1990); *R.W. Roberts Constr. Co. v. St. Johns River Water Mgmt. Dist.*, 423 So.2d 630, 633 (Fla. Dist. Ct. App. 1982). Ms. Appleby’s law firm represented the Subway® franchisor, Doctor’s Associates, Inc., in the cases involving Doctor’s Associates, Inc.

<sup>183</sup> *Armendariz*, 6 P.3d at 691, 694.

<sup>184</sup> *Bischoff v. DirecTV, Inc.*, 180 F. Supp. 2d 1097 (C.D. Cal. 2002).

impermissibly “impose a special burden on agreements to arbitrate.”<sup>185</sup> Similarly, in *Morris*, the court did not find unconscionability where only the merchant and not the credit card company was subject to termination fees.<sup>186</sup> The court held that the one-sidedness did not sufficiently “shock the conscience” so as to establish unconscionability.<sup>187</sup>

## **b. Business Realities**

*Armendariz* also held that certain “business realities” may provide adequate justification for non-mutual provisions.<sup>188</sup> Put another way, “unconscionability turns not only on a ‘one sided’ result, but also on an absence of ‘justification for it.’”<sup>189</sup>

Although “business realities” may justify some contractual non-mutuality, courts will also look beyond the face of the contract and invalidate provisions that purport to be mutual, yet in reality, are not. For example, in *Szetela*, the court invalidated an arbitration provision precluding class actions<sup>190</sup> because the provision was “clearly meant to prevent customers . . . from seeking redress for relatively small amounts of money . . . [and] instead sought to create for [the company] virtual immunity from class or representative actions despite their potential merit, while suffering no similar detriment to its own rights.”<sup>191</sup> Similarly, in *Mercurio v. Superior Court*, another district of the California Court of Appeal also invalidated an arbitration agreement as one-sided and unconscionable because it compelled “arbitration of the claims’ employees [were] most likely to bring against [the employer, yet] exempt[ed] from arbitration the claims [the employer] is most likely to bring against its employees.”<sup>192</sup> Finally, in *Saika v. Gold*, the court invalidated a clause in an arbitration agreement that allowed either party to request a trial de novo for arbitration awards exceeding \$25,000.<sup>193</sup> The court noted that “[a]s a practical matter, the benefit which the trial de novo clause confers on the [plaintiff petitioner] is nothing more than a chimera. The odds that an award will *both* (a) clear the \$25,000 threshold but (b) *still* be so low that the [plaintiff] would *want* to have a trial de novo are so small as to be negligible.”<sup>194</sup>

To summarize, there is at least some conflicting authority within California on key issues that largely determine whether franchise agreements, or clauses, are unconscionable. The last word from California has not yet been written.

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<sup>185</sup> *Id.* at 1110.

<sup>186</sup> *Morris v. Redwood Empire Bancorp*, 27 Cal. Rptr. 3d 797, 810 (Cal. Ct. App. 2005).

<sup>187</sup> *Id.*

<sup>188</sup> *Armendariz v. Found. Health Psychcare Servs., Inc.*, 6 P.3d 669, 692-94 (Cal. 2000); *see also* *Stirlen v. Supercuts, Inc.*, 60 Cal. Rptr. 2d 138, 147-48 (Cal. Ct. App. 1997) (holding that a contract can provide a “margin of safety’ that provides the party with superior bargaining strength a type of extra protection for which it has a legitimate commercial need without being unconscionable”).

<sup>189</sup> *Armendariz*, 6 P.3d 669, 692 (quoting *A & M Produce Co. v. FMC Corp.*, 186 Cal. Rptr. 114, 122 (Cal. Ct. App. 1982)).

<sup>190</sup> *Szetela v. Discover Bank*, 118 Cal. Rptr. 2d 862 (Cal. Ct. App. 2002).

<sup>191</sup> *Id.* at 867.

<sup>192</sup> 116 Cal. Rptr. 2d 671 (Cal. Ct. App. 2002); *see also* *Ferguson v. Countrywide Indus., Inc.*, 298 F.3d 778, 785 (9th Cir. 2002) (same).

<sup>193</sup> 56 Cal. Rptr. 2d 922, 925-26 (Cal. Ct. App. 1996).

<sup>194</sup> *Id.* (italics original).

## **F. The Fate of Typical Franchise Agreement Clauses**

### **1. What Provisions Typically Included in Franchise Agreements are Unconscionable or Potentially Unconscionable Under California Law?**

Providing any definitive answer to this question is virtually impossible for several reasons. First, a potentially unconscionable contract provision must be analyzed on a “sliding scale.”<sup>195</sup> Second, a contract provision cannot be considered in a vacuum. As both Civil Code Section 1670.5 and many courts have recognized, a court should consider the factual circumstances surrounding the agreement, potential “business justifications” and the practical applications of the provision.<sup>196</sup> Notwithstanding, some general guidance can be provided.

### **2. Class Action Waiver Provisions**

While there is some room for argument, it seems reasonably clear that, under cases such as *Mailbox Owners*, a class action waiver provision in a franchise agreement would likely be unenforceable under California law. While the appellate court’s recent holding in *Mailbox Owners* that a provision against class-wide arbitrations was unconscionable should be limited to the facts of that case, California courts and federal courts applying California law have routinely struck down such provisions which are typically unenforceable in both California consumer and employment agreements.<sup>197</sup>

Despite these and similar decisions, it can fairly be argued that a class action waiver provision is not *per se* unconscionable. If there is a “low level” of “procedural unconscionability” and the class action waiver provision is the only term of the agreement that is alleged to be substantively unconscionable, it seems that the concerns articulated by the courts in *Mailbox Owners* (franchise agreement), *Szetela* (credit card agreement) and *Ingle* (employment agreement), as well as by other courts are not present or, if so, to a much lesser degree. For example, the public policy reasons for finding such provisions unconscionable and, therefore, unenforceable in the consumer setting are not as pronounced in franchising. Franchise disputes generally do not involve the sort of small individual damages that often characterize consumer cases and that make the class action procedure the only practical way to pursue claims. Moreover, while there may be a difference in bargaining power, a potential franchisee typically has many other choices and is generally at least somewhat sophisticated in business matters.

### **3. Arbitration Fee-Splitting Provisions**

Many franchise agreements require that some or all disputes be arbitrated and that the parties split the cost of the arbitration. In *Mailbox Owners*, the court concluded that the

<sup>195</sup> *Armendariz v. Found. Health Psychcare Servs., Inc.*, 6 P.3d 669, 690 (Cal. 2000) (“The more substantively oppressive the contract term, the less evidence of procedural unconscionability is required to come to the conclusion that the term is unenforceable, and vice versa.”)

<sup>196</sup> See, e.g., *id.* at 694 (there must be a “reasonable justification” for a unilateral arbitration agreement – “i.e., a justification grounded in something other than the employer’s desire to maximize its advantage . . . .”); *Perdue v. Crocker Nat’l Bank*, 702 P.2d 503, 512 (Cal. 1985) (a “claim of unconscionability often cannot be determined merely by examining the face of the contract, but will require inquiry into its [business] setting, purpose and effect”).

<sup>197</sup> See, e.g., *Ingle*, *supra* note 172, at 1175-76 (class action waiver provision in an employment agreement literally applied to both employer and employees, but in reality, only the employees would use the class action procedure; provision unconscionable).

franchisees' claims under the California Franchise Investment Law, the Cartwright Act (antitrust), the Uniform Trade Secrets Act and the Unfair Competition Law were "statutory," affected the "public interest" and "appear[ed]" to fall in whole or part within the holdings of *Armendariz and Boghos v. Certain Underwriters at Lloyd's of London*.<sup>198</sup> As a result, the court concluded that the franchisees were entitled to an advance fee allocation ruling before the arbitration proceedings commenced.<sup>199</sup>

The holding in *Mailbox Owners* is significant because it expressly applied the prohibition against a fee-shifting provision insofar as it involves a "statutory" claim to a number of statutes that are the sources of many franchisee claims against franchisors. While the court's conclusions are subject to attack, it seems generally unlikely that other California courts will reach a different result on the fee shifting issue.

#### **4. Damage Limitation Provisions**

It seems reasonably clear that provisions purporting to limit the remedies that might otherwise be available to a franchisee for a statutory claim are unenforceable under California court precedent.<sup>200</sup>

#### **5. Truncated Statute of Limitations Provisions**

Several courts applying California law have invalidated provisions purporting to require parties to pursue their claims more quickly than required by statute. For example, in *Ingle*<sup>201</sup>, and *Adams*<sup>202</sup> the Ninth Circuit found substantively unconscionable a provision requiring Circuit City employees to demand arbitration within one year of when the employee knew or should have known of the facts giving rise to the claim. While the courts in both *Ingle* and *Adams* invalidated the statute of limitations provision at issue because it effectively limited the "continuing violation doctrine available in FEHA<sup>203</sup> suits," the holding of these cases could be extended to other circumstances involving "statutory" claims.

#### **6. Confidentiality Provisions**

A confidentiality provision within an arbitration agreement is also likely to be unenforceable under California law.<sup>204</sup> Given the disclosure obligations of a franchisor, the holdings of these cases seem to be of relatively little import.

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<sup>198</sup> *Mailbox Owners*, *supra* note 142, at 675 (citing *Armendariz v. Found. Health Psychcare Servs., Inc.*, 6 P.3d 669, 689-90 (Cal. 2000) & *Boghos v. Certain Underwriters at Lloyd's of London*, 115 P.3d 68 (Cal. 2005)).

<sup>199</sup> *Id.* at 676.

<sup>200</sup> *See id.* at 671-73.

<sup>201</sup> *Ingle*, *supra* note 172, at 1175.

<sup>202</sup> *Adams*, *supra* note 162, at 892-95.

<sup>203</sup> For an overview of the California Fair Employment and Housing Act ("FEHA"), CAL. GOV'T CODE §§ 12900 *et seq.*, see 2005-8A FAIR EMPLOYMENT PRACTICES MANUAL (BNA) 453:2701 ("The [FEHA] prohibits employment discrimination on the basis of race, religious creed, color, age, national origin, ancestry, physical ability, mental disability, medical condition, marital status, sex, or sexual orientation.").

<sup>204</sup> *See, e.g.*, *Ting v. AT&T*, 319 F.3d 1126, 1151-52 (9th Cir. 2003) (telephone customer agreement; a facially neutral confidentiality clause within arbitration agreement was unconscionable because "if [defendant company] succeeds in imposing a gag order, plaintiffs are unable to mitigate the advantages inherent in being a repeat player"); *ACORN v.*

**G. Extraterritorial Effects of the Recent California and Ninth Circuit Decisions**

If you do not practice on the West Coast, you may be inclined to dismiss the recent cases as mere “California aberrations.”<sup>205</sup> However, the First Circuit’s recent decision in *Kristian v. Comcast Corp.*, in which the court struck down provisions precluding class arbitration and recovery of treble damages and attorney fees because they frustrated the vindication of federal and state statutory rights, suggests otherwise.<sup>206</sup> We respectfully submit that regardless of where you practice, you will soon confront, if you have not already, the same issues that arose in cases such as *Mailbox Owners*.

**VI. MATTERS OF PERSPECTIVE**

**A. Is Arbitration the Problem?**

Is it possible that unconscionability’s long dormancy, and now its possible resurgence, have more to do with fluctuating judicial attitudes towards arbitration, as opposed to judicial attitudes toward unconscionability itself? Referring to the many long years in which unconscionability was the argument of last resort, at least one commentator had previously linked “unconscionability’s fall from grace and arbitrations’ ascendance.”<sup>207</sup> This connection has some logical appeal, given the current climate in California and the Ninth Circuit where the rise and fall are arguably reversed or in the process of reversing.<sup>208</sup> Interestingly, some franchisors have also begun to lose enthusiasm for arbitration.<sup>209</sup>

**B. Can Franchise Agreements Ever Really be Contracts of Adhesion?**

In once sense, there is clearly a “lack of meaningful choice” with respect to many or most franchise agreement terms, at least when dealing with established franchisors, which do

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Household Int’l, Inc, 211 F. Supp. 2d 1160, 1171-72 (N.D. Cal. 2002) (confidentiality clause in arbitration provision of loan agreement; same holding).

<sup>205</sup> For a discussion of California’s sometimes iconoclastic approach to contract interpretation, please see W. Andrew Scott & R. Samuel Snider, *California Populism, Contract Interpretation, and Franchise Agreements*, 24 FRANCHISE L.J. 248 (2005).

<sup>206</sup> 446 F.3d 25 (1st Cir. 2006); see also *Sprague v. Household Int’l*, No. 04-0106-CV-W-NKL, 2005 U.S. Dist. LEXIS 11694 (W.D. Mo. June 15, 2005) (finding a class action waiver substantively unconscionable but nonetheless enforcing the arbitration provision which contained the class action waiver, because the case at bar was not a class action).

<sup>207</sup> Stempel, *supra* note 25, at 764.

<sup>208</sup> Adding support to this conclusion, recent Forums have included programs that substantially question the wisdom of mandatory arbitration from the franchisor standpoint.

<sup>209</sup> At the Forum in 2005, the merits of arbitration, from the franchisor perspective, were openly questioned, as it was observed that:

Anecdotal evidence suggests that many franchisors are either abandoning arbitration altogether or using more carve-out provisions . . . . And franchisee advocates have already succeeded in piercing at least one hole in the armor of the Federal Arbitration Act (“FAA”). By virtue of a 2002 amendment, motor vehicle dealer agreements are now outside the FAA’s scope . . . [and] the arguments that won passage of this amendment could justify exempting all franchise agreements from the FAA.

Edward Wood Dunham & Michael J. Lockerby, *Shall We Arbitrate? The Pro’s And Cons Of Arbitrating Franchise Disputes*, A.B.A. FORUM ON FRANCHISING, at 3 (2005). Mr. Dunham is Ms. Appleby’s partner at Wiggin and Dana LLP.

not usually negotiate the terms of their franchise agreements. Courts have therefore sometimes found that franchise agreements are “contracts of adhesion.”<sup>210</sup> However, even franchisee advocates must admit that, before signing the first franchise agreement, a prospective franchisee still has the choice of not signing at all, as becoming a franchisee is not usually considered a “necessity” of life. Also, the prospective franchisee can certainly compare contract terms in shopping among different franchise systems, although on this point, many franchisee advocates have complained that too many harsh terms have become prevalent. In any event, the franchisee always has some significant degree of choice in deciding whether to become a franchisee in any particular system. Accordingly, a franchisor’s mere refusal to negotiate standard terms in its franchise agreement is rarely deemed sufficient to establish unconscionability.<sup>211</sup> Thus, most courts have concluded that the standard form nature of contracts, without more, does not *necessarily* make them unconscionable (and in the opinion of many franchisor attorneys, a standard form of contract, standing alone, should *never* suffice to establish unconscionability -- if this were enough, companies would be compelled to negotiate every contract individually, and organized business as we know it would grind to a halt).

### **C. The Problems of Characterization**

By now, it should be clear to all that the doctrine of unconscionability, an equitable doctrine that judges (rather than juries) must apply, has been inconsistently applied and widely criticized. The question of procedural unconscionability invites subjective judicial *characterization*: In just about every case, the courts make “findings” as to the character of the parties, the transaction process, and the contract terms. Thus, findings of unconscionability tend to occur when the franchisor is “strong,” the franchisee is “weak,” and both the process and the resulting contract terms are “unfair.” All of this creates the risk of result-oriented decisions.

Unfortunately, courts often make these characterizations through a process of labeling as opposed to making decisions based on evidence. The Code’s admonition in Section 2-302(2) that “*the parties shall be afforded a reasonable opportunity to present evidence as to . . . commercial setting, purpose and effect to aid the court in making the determination*” has largely been ignored.

The problem of characterization, without evidence, may be particularly acute in franchising, given the conflicting views of franchisees as analogous to “employees” or “consumers,” on one hand, or “independent business owners,” on the other.

#### **1. The Franchisee as “Employee”**

Against the backdrop of growing franchisee attempts to bargain collectively, we review the question of whether courts are likely to follow the lead of cases such as *Mailbox Owners*, in which the court also likened franchisees to employees. Whether franchisees are comparable to employees is frequently an issue in litigation over covenants not to compete. However, the results outside of California are not encouraging to franchisees. In many states, covenants not to compete are disfavored when signed by employees, but favored when signed in the “sale of

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<sup>210</sup> See, Appendix 4 for a list of representative cases.

<sup>211</sup> See, e.g., *Shaffer v. Graybill*, 68 Fed. App’x 374 (3d Cir. 2003) (noting that an adhesion contract is not unenforceable unless it is “unconscionable or oppressive, unreasonably favoring one party over the other”) (non-precedential opinion); *Gilmer v. Interstate/Johnson Lane Corp.*, 500 U.S. 20, 32-33 (1991) (rejecting notion that adhesion contracts are unconscionable simply by virtue of the parties’ disparate bargaining power); *Seus v. John Nuveen & Co.*, 146 F.3d 175, 184 (3d Cir. 1998) (same), *overruled on other grounds by* *Green Tree Fin. Corp.-Alabama v. Randolph*, 531 U.S. 79 (2000).

business”.<sup>212</sup> Therefore, courts are often called upon to decide whether franchising more closely resembles an employment relationship or a sale of a business. The majority of courts that have addressed this issue have resolved it against the franchisee, with the “sale of business” characterization prevailing over the employment analogy, based largely on the transfer of goodwill from the franchisor to the franchisee, and the legitimate need to protect that goodwill from competition.<sup>213</sup> The likely reluctance of other jurisdictions to embrace the *Mailbox Owners* view of franchising as akin to employment is an obstacle that franchisees seeking to invoke *Mailbox Owners* will have to overcome.<sup>214</sup>

## 2. The Franchisee as “Consumer”

Franchisees may also continue to argue that they are analogous to “consumers,” since the Federal Trade Commission arguably treats franchisees as consumers for purposes of its regulation of the sales process,<sup>215</sup> and franchisees typically have standing under state consumer fraud laws.<sup>216</sup> Franchisees making the consumer argument should present evidence of the ways in which their franchisor brought the franchise to market, as franchise opportunities are typically advertised extensively in a manner comparable to the consumer marketing of products and services. However, while *some* franchisees might experience greater success in the future arguing that they are consumers for purposes of unconscionability claims, the problems of generalization among widely varying franchisees, discussed above, will remain. This problem was illustrated by the dissent in *Ticknor*, which argued vigorously that the owner of two hotels was not a consumer “under any definition of the term.”<sup>217</sup>

Moreover, franchisee efforts to establish themselves as helpless consumers for purposes of procedural unconscionability may prove difficult because, unlike typical consumers, they enjoy the disclosure protections of the FTC rule and various state disclosure laws. Before any lawful franchise sale, material terms are disclosed, and a cooling-off period is imposed. Arguably, the FTC Rule and its state counterparts negate the element of “surprise” in franchising. Again, it is worth noting that the California line of cases that equate adhesion alone

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<sup>212</sup> See generally the discussion of non-competition agreements in franchising set forth in KLARFIELD, COVENANTS AGAINST COMPETITION IN FRANCHISE AGREEMENTS (2d ed. 2003).

<sup>213</sup> *Id.* See also, *Haagen-Dazs Shoppe Co. v. Morton*, No. 94-S-2457, Bus. Franchise Guide (CCH) ¶ 10,587 (D. Colo. Dec. 9 1994); *Economou v. Physicians Weightloss Ctrs. of Am.*, 756 F. Supp. 1024, 1032 (N.D. Ohio 1991); *ATL Int'l, Inc. v. Baradar*, No. JFM-97-3642, Bus. Franchise Guide (CCH) ¶11,345 (D. Md. Nov. 12, 1979); *Shakey's Inc. v. Martin*, 430 P.2d 504, 510-11 (Idaho 1967); *Casey's Gen. Stores v. Campbell Oil Co.*, 441 N.W.2d 758, 761-62 (Iowa 1989); *Baldwin v. Stuber*, 597 P.2d 1135, 1138-39 (Mont. 1979); *Disc. Muffler Shops, Inc. v. Seely*, No. L-83-048, 1983 WL 6849, at \*3 (Ohio Ct. App. July 1, 1983); *Piercing Pagoda, Inc. v. Hoffner*, 351 A.2d 207, 211-12 (Pa. 1976); *Armstrong v. Taco Time Int'l*, 635 P.2d 1114, 1117-18 (Wash. Ct. App. 1981).

<sup>214</sup> The *Mailbox Owners* holding is certainly consistent with cases construing California's statutory prohibition against the enforcement of non-competes that would prohibit a person from engaging in a “lawful profession, trade or business of any kind” absent an express statutory exemption. CAL. BUS. & PROF. CODE §§ 16600-16607 (1976). The same chapter carves an exception for non-competes that are signed as part of the sale of a business, *id.* at § 16601, but the cases applying this statute have declined to view franchising as the sale of a business. See, e.g., *Scott v. Snelling & Snelling, Inc.*, 732 F. Supp. 1034, 1040-41 (N.D. Cal. 1990).

<sup>215</sup> The franchise sales process is regulated by the Consumer Protection Bureau of the FTC. See <http://www.ftc.gov/ftc/consumer.htm> (follow link for “Franchise & Business Opportunities”), and <http://www.ftc.gov/bcp/menu-fran.htm>.

<sup>216</sup> See, e.g., *Morgan v. Air Brook Limousine, Inc.*, 510 A.2d 1197 (1986); *Bailey Employment Sys., Inc. v. Hahn*, 545 F. Supp. 62 (D. Conn. 1982), *aff'd without opinion*, 723 F.2d 895 (2d Cir. 1983).

<sup>217</sup> *Ticknor v. Choice Hotels Int'l, Inc.*, 265 F.3d 931, 942-43 (9th Cir. 2001) (Tashima, J., dissenting).

with procedural unconscionability have ignored the question of how a franchisee with the benefit of FTC-mandated disclosures can be the victim of surprise.

Franchisors seeking to negate the element of “surprise” can be expected to present evidence that the franchisee received the benefits of the disclosure rules, and franchisors can heighten the impact of this evidence in a number of ways -- e.g., by highlighting the franchisee’s acknowledgment that he or she was advised to have the agreement reviewed by a lawyer (and business advisor), in addition to the increasingly common practice of having the franchisee initial every page, or every controversial clause, in the franchise agreement.

For their part, franchisees can hardly complain about heightened disclosure, even if it cuts against an unconscionability argument. Franchisors would be well served by introducing evidence that differentiates the franchise relationship from a consumer or employment one and, at least for claims in an individual case by sophisticated franchisees, should also introduce evidence concerning the franchisees’ education and experience. Franchisors should also make clear that franchisees often seek substantial damages (such as the value of the business and/or lost profits), and that the problem discussed in *Szetela*, where the defendant could breach its contracts with impunity because each individual claim was so small that no wronged consumer would ever pursue it, does not apply.

Franchisees, on the other hand, should introduce evidence concerning any disparity in wealth and bargaining power between them and the franchisor, and should alert the court if they do not have substantial business experience or formal education. In addition, franchisees should be prepared to present evidence, when applicable, that their efforts at negotiating the terms of the franchise agreement were rebuffed, in whole or in part.

### **3. Characterization Can Be Outcome Determinative**

How a court chooses to characterize a franchisee can be outcome-determinative. In *We Care Hair*, the Seventh Circuit summarily held in 1999 that fifty-three hair-cutting franchisees were “not vulnerable consumers or helpless workers but rather business people who bought a franchise” without discussing the particular economic circumstances or business experience of any single franchisee.<sup>218</sup> There is simply no indication from the Seventh Circuit opinion that either side presented any evidence on these issues, aside from the undisputed evidence that the franchisees had purchased franchises and signed franchise agreements, which the court apparently found sufficient to remove them from the realm of consumers or employers.

Contrast the holding of the Seventh Circuit in *We Care Hair* with the California appellate opinion in *Mailbox Owners*, where the court opined that “the franchise factual context is sufficiently similar to mandatory employer/employee arbitration [and] consumer arbitration,” leading to a pro-franchisee outcome.<sup>219</sup> In support of this finding, the franchisees had cited previous California decisions that had also described the franchise relationship as typically presenting unequal bargaining power, but nowhere does it appear that evidence of procedural unconscionability was actually presented in *Mailbox Owners*.<sup>220</sup> Characterization carried the day.

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<sup>218</sup> *We Care Hair Dev., Inc. v. Engen*, 180 F.3d 838, 843 (7th Cir. 1999) (internal quotations and citations omitted).

<sup>219</sup> Compare *id.* at 843 with *Mailbox Owners*, *supra* note 142, at 676.

<sup>220</sup> *Petition for Writ of Prohibition, Mandate and/or Other Appropriate Relief* at 55-57, *Mailbox Owners*, *supra* note 142 (No. GIC 814146) (citing *Keating v. Super. Ct.*, 645 P.2d 1192, 1196 (Cal. 1982); *E.S. Bills, Inc. v. Tzucanow*, 700

And yet, proving that for every rule there is an exception, consider *Days Inns Worldwide, Inc. v. Mehta*, a 2005 decision from the Southern District of Georgia, where the district court rejected the contention of a hotel franchisee that certain termination provisions in the franchise agreement were unconscionable:

Mehta attempts to establish “grossly disproportionate bargaining power” by pointing out that English is his second language and that he is “not sophisticated in the realm of business, hotel management, or law . . . . Yet, I have read Mehta’s deposition in its entirety and do not find that his knowledge of the English language is so wanting that it renders his bargaining power inferior to the point of unfairness. In fact, I found that Mehta understood the questions and the deposition proceeding, which took place in English, rather well. Moreover, Mehta had previously entered into a franchise agreement with Days Inn in Eastman, Georgia; he had managed both hotels largely by himself for many years; and he had formed two corporations for the purpose of entering into franchise agreements. Mehta also holds a degree in civil engineering. This is simply not a man of such inferior bargaining power as to warrant this Court’s protection. Finally, to the extent that Mehta complains that some of the contractual provisions are unduly complex, the Court notes that Mehta admits to not having read the License Agreement when he signed it. Accordingly, the alleged complexity of its terms is irrelevant to Mehta’s argument concerning inequality of bargaining power during execution of the agreement.<sup>221</sup>

Mindful that a court, as in *Mehta*, may want to weigh the evidence, lawyers for both franchisors and franchisees should seek to present any helpful information about the education level and sophistication of the franchisee in question, and should consider presenting evidence of the “setting, purpose and effect” of contract terms in franchising. This latter topic would appear ripe for appropriate expert testimony from an experienced franchise attorney, or executive or consultant, who could explain the purpose of the clauses, and the extent to which the clauses have been widely used in franchising. Franchise lawyers may also want to consider presenting evidence concerning the size of the franchise market in general today, as well as the plethora of franchisors of different types and sizes -- or the lack thereof -- from which prospective franchisees may choose.

#### **D. The Potential for Inconsistency**

Among the most troubling potential problems arising from characterization-based decisions are inconsistent results. Is a publicly-traded multi-unit, multi-system corporate franchisee in the need of the same protection as an individual who has not gone to college and is buying his or her first small business franchise? Perhaps not. Likewise, is a small but successful business trying to sell its first franchise in the same position as a “large wealthy

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P.2d 1280, 1288 (Cal. 1985); *Postal Instant Press, Inc. v. Sealy*, 51 Cal. Rptr. 2d 365, 373 (Cal. Ct. App. 1996)). The authors thank Forum Members Peter Lagarias and Michael Hanks for supplying a copy of the franchisees’ Petition for Writ in *Mailbox Owners*, and likewise thank Forum Member Barry Heller for supplying a copy of the franchisors’ responses.

<sup>221</sup> *Days Inns Worldwide, Inc. v. Mehta*, No. CV 304-092, 2005 U.S. Dist. LEXIS 20803, at \*12-13 (S.D. Ga. Sept. 7, 2005).

international franchisor”?<sup>222</sup>

For legislators or regulators, the problem of “different sizes” is usually ignored in the promulgation of prophylactic rules designed to protect the weak, and which, at worst, are unnecessary to protect the strong. However, for courts, the inescapable fact that both franchisees and franchisors come in different economic sizes poses at least two very real problems in applying the doctrine of unconscionability.

First, there is an obvious risk of inconsistency within a single system as to whether any particular contract language is unconscionable, depending on the relative strength of the franchisor and franchisee in a particular case. A court could find that a particular clause is enforceable with respect to one franchisee but unenforceable with respect to another franchisee in the same system. Second, there is the risk that the identical or substantially similar contract provisions could be held unconscionable when enforced by a strong and well-established franchisor, but not when the franchisor is relatively weak.

In both of these scenarios, the presumed goal of predictability based on precedent may be difficult if not impossible to achieve. Further, the whole approach of deciding unconscionability based on the relative strength of the parties requires difficult exercises in line-drawing. The varying results could be influenced by the socio-economic views of the particular jurists, resulting in potentially arbitrary and capricious decisions.

However, despite our expressed enthusiasm for actually presenting evidence, it is difficult to imagine that courts will actually want to hold trials in which the central issue, having survived summary judgment, is whether the particular franchisee had sufficient economic capacity to agree intelligently to provisions that would be “shockingly unfair” absent the franchisee’s wealth and experience. These issues are likely to be resolved summarily by motions, which will also tend to yield arbitrary results. So far, the unconscionability cases have not seriously grappled with the growing phenomenon of the economically sophisticated franchisee or the resulting potential for inconsistent results.<sup>223</sup>

#### **E. The “Market Power” Contradiction**

The *Ticknor dissent* lamented that the majority found unconscionability despite the lack of evidence that the franchisees were without meaningful alternatives, *i.e.*, that they could not have entered into an agreement with a different hotel franchisor.<sup>224</sup> This observation raises interesting questions as to whether courts should look to “tying” cases under Section 1 of the Sherman Act, 15 U.S.C § 1, when analyzing franchisees’ unconscionability claims.

In tying cases, courts have consistently held that franchisors lack sufficient “market power” in the tying product (their franchises) to compel franchisee purchases of a “tied” product,

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<sup>222</sup> Bolter v. Super. Ct., 104 Cal. Rptr. 2d 888, 893 (Cal. Ct. App. 2001) (accepting the franchisee’s characterization of the franchisor and noting that the franchisor “made no attempt to refute [that] characterization”).

<sup>223</sup> See, John R.F. Baer et al., *Franchising: Distribution Model For the Millennium?*, A.B.A. FORUM ON FRANCHISING § 1-4, at 26 (1999) (discussing the emergence of the “Mega Franchisee”). In *Postal Instant Press*, the appellate court at least acknowledged that franchisees come in a variety of sizes, stating that: “Franchisees typically, *but not always*, are small businessmen or businesswomen or people like [the franchisee in that case] seeking to make the transition from being wage earners and for whom the franchise is their very first business.” 51 Cal. Rptr. 2d at 373 (emphasis added).

<sup>224</sup> *Ticknor v. Choice Hotels Int’l, Inc.*, 265 F.3d 931, 942-43 (9th Cir. 2001) (Tashima, J., dissenting).

e.g. a particular soft-drink to be served in a quick service restaurant<sup>225</sup> or the ingredients for a pizza.<sup>226</sup> In these cases, the courts have flatly rejected the contention that, at the time of the franchise sale, the franchisor has sufficient economic power to impose its will upon a new franchisee, by dictating the terms of the franchise agreement. For example:

The important economic distinction that must be made is between pre- and postcontract economic power. Precontract, competition among franchisors (such as McDonald's or Kentucky Fried Chicken) to sign up franchisees prevents [a single franchisor] from exercising any economic power in setting contract terms with potential franchisees. [The franchisor], although it possesses a trademark, does not possess any economic power in the market in which it operates -- the fast food franchising (or perhaps, more generally, the franchising) market.<sup>227</sup>

Likewise:

McDonald's was a pioneer, but one need only step outside this courthouse to observe perhaps half a dozen fast food franchises within a block. Driving along a strip commercial area is a continuous exposure to a cacophony of presumed gastronomical delights. Indeed, plaintiffs do not allege that kind of market power and this court is unaware of any intention to assert or seek to prove that here.

We are talking about a market in which there is competition for new franchisees. Obviously there is almost invariably disparate economic power between a franchisor and an already existing single franchisee, although the cooperative efforts of franchisees may more evenly balance that economic power; and the self interest of the franchisor which, after all, must seek more franchises and keep existing franchisees relatively satisfied, may mute the exercise of power. That disparity has led to both state and federal legislation to curb franchise abuses, and the introduction of some restraints upon pain of termination may well violate the antitrust laws. Here, however, we are dealing with requirements which always, or at least for many years, have been part of the franchise agreements.<sup>228</sup>

We omit discussion of the ways in which franchisees might attempt to prove market share. Suffice it to say that these holdings are very difficult, if not impossible, to reconcile with the contrary premise of the unconscionability doctrine, which is that, in cases where the court accepted the franchisee's claim of unconscionability, the franchisor allegedly had sufficient "economic power in setting contract terms with potential franchisees."<sup>229</sup> Courts may eventually have to confront this contradiction. So far, the courts have largely avoided the issue by focusing more on the process of negotiation -- e.g., the refusal to bargain or other tactics that franchisees often find high-handed, rather than the franchisor itself. In *Weaver v. American Oil*,<sup>230</sup> for

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<sup>225</sup> *Martino v. McDonald's Sys., Inc.*, 625 F. Supp. 356 (N.D. Ill. 1985).

<sup>226</sup> *Queen City Pizza, Inc. v. Domino's Pizza, Inc.*, 922 F. Supp. 1055 (E.D. Pa. 1996), *aff'd*, 124 F.3d 430 (3d Cir. 1997), *cert. denied*, 523 U.S. 1059 (1998).

<sup>227</sup> *Id.* at 1061 (quoting Benjamin Klein & Lester F. Saft, *The Law and Economics of Franchise Tying Contracts*, 28 J. LAW & ECON. 345, 356 (1985)) (alterations in original by court).

<sup>228</sup> *Martino*, 625 F. Supp. at 361.

<sup>229</sup> *Queen City*, 922 F. Supp. at 1061 (quoting Klein, *supra* note 227).

<sup>230</sup> 276 N.E.2d 144, 146 (Ind. 1971).

example, evidence that an oil company neither explained the provisions of an agreement prepared by its attorneys to a poorly-educated gas station operator nor advised the latter to seek legal counsel led the court to conclude that the superior bargaining power of the oil company was “patently obvious.”<sup>231</sup>

On this score, it is worth recalling how certain California courts have avoided confronting this issue by holding, in essence, that procedural unconscionability is present whenever the franchise agreement is classified as an adhesion contract.<sup>232</sup> The “market power” line of tying cases presumably would contradict the notion that anyone was “forced” to buy any particular franchise, or to accept any particular clause in their franchise agreement.<sup>233</sup>

The Seventh Circuit has already rejected the notion that “franchisees were *forced* to swallow unpalatable terms” in the franchise acquisition process, but it has thus far reached this conclusion by characterizing the franchisees as independent business persons, not by focusing on the franchisor’s alleged market power.<sup>234</sup>

## **F. Renewing Franchises And Market Power Issues**

Consider the dilemma faced by a franchisee whose initial agreement provides for renewal only as long as certain conditions are met, and only upon execution of the franchisor’s “then-current” form of agreement. If, upon renewal, the franchisee is presented with materially different terms than had been contained in the original franchise agreement, the element of “choice” in accepting the new terms is arguably illusory, as the renewing franchisee is hardly in position to walk away from its substantial equity investment. In this situation, the franchisor effectively has a captive market. In *Martino v. McDonald’s*, the district court specifically noted that “[o]bviously, there is almost invariably disparate economic power between a franchiser and an already existing single franchisee, . . . .”<sup>235</sup> Similarly, the *Bolter* court’s unconscionability finding relied, at least in part, on the fact that the disputed arbitration provision was added during the renewal process after the franchisees were already “locked in” with a particular franchisor.<sup>236</sup> The courts’ language in these cases certainly suggests that a renewing franchisee might potentially fare better than a new franchisee on the issue of procedural unconscionability. The renewal issue could very well serve as a potent weapon for franchisees seeking to challenge the new terms of their agreements as unconscionable, but only, it would seem, where the terms challenged had not been part of the original franchise agreement.

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<sup>231</sup> *Id.*

<sup>232</sup> See, Leff, *supra* note 10, at 504-06.

<sup>233</sup> MBE apparently did not raise this argument in *Mailbox Owners*. In challenging the allegation of procedural unconscionability, MBE cited the line of cases holding that not every contract of adhesion should be deemed procedurally unconscionable, and then focused on the lack of “surprise” since the terms were clearly apparent and fully disclosed. See *Letter Brief Dated Feb. 22, 2005 in Response to Petitioner’s Petition for Writ of Prohibition, Mandate and/or Other Appropriate Relief* at 6-9, *Mailbox Owners*, *supra* note 142 (No. GIC 814146).

<sup>234</sup> *We Care Hair Dev., Inc. v. Engen*, 180 F.3d 838, 843 (7th Cir. 1999) (quoting *Original Great Am. Chocolate Chip Cookie Co., v. River Valley Cookies, Ltd.*, 970 F.2d 273, 281 (7th Cir. 1992)) (internal quotation marks omitted).

<sup>235</sup> *Martino v. McDonald’s Sys., Inc.*, 625 F. Supp. 356, 361 (N.D. Ill. 1985).

<sup>236</sup> *Bolter v. Super. Ct.*, 104 Cal. Rptr. 2d 888, 894 (Cal. Ct. App. 2001).

## **G. The Effect of Franchisee Associations**

As a corollary to the question whether franchisors are sufficiently strong to “force” harsh terms upon franchisees, will courts take notice of increasing franchisee efforts to engage in “collective bargaining” through independent franchisee associations, or umbrella associations such as the American Association of Franchisees & Dealers? Indeed, almost as though it was anticipating this very question in 1985, the district court in *Martino v. McDonald’s* continued after observing that a franchisor’s economic power over its franchisees is increased after the agreement is signed and the franchisee is invested, also noted that:

the cooperative efforts of franchisees may more evenly balance that economic power; and the self interest of the franchiser which, after all, must seek more franchises and keep existing franchisees relatively satisfied, may mute the exercise of power [by the franchisor].<sup>237</sup>

Franchisors that are reluctant to bargain with an independent association regarding the terms of their agreements with an independent association, or to even “recognize” the existence of the association, might wish to reconsider that position if the doctrine of unconscionability begins to flourish. What better defense could there ever be to the charge of unconscionability than to present evidence of good faith bargaining over terms with the association? But even where a franchisor refuses to negotiate with an association, the existence of an association and its role in educating its members, and prospective franchisees, could arguably become relevant in determining whether a franchisee can accurately be characterized as “weak.”

There may well come a day when franchisee collective bargaining efforts provide the death knell for unconscionability in franchising, but that day has not arrived. Until then, two conclusions are reasonably drawn. First, success at the bargaining table, and not successful unconscionability challenges, should remain the ultimate guide for franchisees and their advocates. For franchisees, unconscionability challenges are perhaps best viewed as incentives for franchisors to negotiate, albeit the strength of this incentive is not yet known. Second, as the doctrine of unconscionability evolves, and as more franchisees attempt to negotiate with their franchisors, we predict less “characterization” and more evidence, as to the relative strength and sophistication of the contracting parties and the contract formation process, in support of, and in opposition to, particular unconscionability challenges.

## **H. Problems in Substantive Unconscionability**

### **1. “Business Reality” -- the System or the Individual Franchisee?**

Many franchising clauses are double-edged swords. A franchisee forced to arbitrate a claim, waive the right to seek punitive damages, or seek class action status, may contend that these provisions are unfair, and that they only benefit the franchisor. In the same vein, a “lack of mutuality” in remedies appears unfair to an individual franchisee with a grievance.

However, some of those clauses might arguably be viewed as benefiting other franchisees in the system who are not in dispute with the franchisor. To be sure, franchisees can still argue that clauses that serve to limit franchisee remedies remain destructive to franchising, by encouraging bad behavior on the part of some franchisors, but the point for the purposes of discussing substantive unconscionability is whether such clauses cross the line and

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<sup>237</sup> 625 F. Supp. at 361.

“shock the conscience” etc., or whether they are at least defensible risk reduction strategies arguably benefiting the entire system, such that courts should be reluctant to disturb the parties’ express allocation of risks. In the cases thus far, we have not seen this argument made. The “business reality” subject is another area in which expert testimony might be expected to help determine which contract provisions arguably protect the entire system, including the franchisor, and which can rightly be viewed as benefiting *only* the franchisor.

## **2. Unfair, Incomplete, or Ambiguous?**

Justice Sandra Day O’Connor has observed that “a determination that a contract is ‘unconscionable’ may in fact be a determination that one party did not intend to agree to the terms of the contract.”<sup>238</sup> More often, perhaps, a franchisee will acknowledge agreement with the express terms, as written, but sharply disagree with the franchisor’s later interpretation or implementation of those terms. Arguably, franchisees suffer more unfavorable outcomes as the result of franchisor conduct in the face of contract provisions that were incomplete or ambiguous at the time of contracting. Some examples:

- An agreement provides that the franchisor shall not open any competing stores within a defined franchise territory. Is the franchisor barred from soliciting Internet sales in the territory? Mail order sales? What do the words “shall not open a store” really mean?
- An agreement provides that the franchisor agrees to “furnish national account leads” to the franchisee. What does it mean to “furnish” a business “lead?” How is a “national account” defined, absent a definitional clause elsewhere in the agreement? Is the “duty” to “furnish national account leads” change when the franchisee has a defined territory in which it might attempt to service a national account?
- An agreement provides that the franchisor may designate sources of supply. From this language alone, is the franchisor able to derive a profit in the form of supplier rebates? If the rebate is permitted, because among other things it was disclosed in the Offering Circular, is there any limit on the amount of the rebate, or the price that the franchisee may be charged? Can the resulting charges to the franchisee exceed market prices?
- An agreement provides that the franchisor may terminate the franchise agreement without notice and without opportunity to cure, on the occurrence of multiple defaults or violations of the agreement, but without requiring that any of the accumulated prior defaults or violations be “material.”

In each of these examples, the franchisee is vulnerable to an unfavorable outcome, resulting from the wide-open language that the parties “bargained for.” Moreover, the franchisee’s post-contracting vulnerability to unfavorable outcomes, based on the franchisor’s opportunity to interpret loose contract language in a self-serving way, is heightened by the fact that, after the sale, the franchisee considering a challenge is now invested in the particular franchise, and vulnerable to termination and the possible loss of equity.<sup>239</sup>

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<sup>238</sup> *Am. Airlines v. Wolens*, 513 U.S. 219, 249 (1995) (O’Connor, J., concurring in the judgment in part and dissenting in part).

<sup>239</sup> See, e.g., *Martino*, 625 F. Supp at 361 (carefully distinguishing between the franchisor’s pre-sale and post-sale powers to impose harsh results on franchisee).

For franchisees, is unconscionability the best argument for challenging clauses that are ambiguous or incomplete? The answer may be “yes” when they have the benefit of a statute that proscribes unconscionable *conduct*, as indicated by the summary of “franchisee successes” in Section IV.E., *supra*. However, if no such statute proscribing unconscionable conduct is available, then franchisees may be left trying to make new law -- *i.e.*, a post-sale doctrine of “unconscionable conduct” or “unconscionable results.” Such a doctrine will certainly meet wide and deep resistance as an attempt to resurrect a broad fiduciary duty. Therefore, for the foreseeable future, franchisees must continue to resort to claims based upon the implied covenant of good faith and fair dealing, for it is not clear that the doctrine of unconscionability will reach contract terms that create the potential for unfair results, which contradict the franchisee’s reasonable expectations at the time of contracting, as opposed to being unfair on their face.<sup>240</sup>

Other commentators have reached the same conclusion, based on the observation that franchise agreements are relational contracts -- contracts that require mutual performance over a number of years. Accordingly, they are necessarily incomplete in defining the parties’ precise duties in every situation, and necessarily vest discretion, especially in the franchisor, as to exactly how the agreement will be performed over a period of years.<sup>241</sup> As observed in an influential 1990 Law Review article critical of franchisors and popular with franchisee lawyers:

Courts have experimented with a number of other doctrinal tools. Doctrines of adhesion, unconscionability, and fiduciary duty have all had brief lives in the franchising context . . . . Most courts . . . have rejected all of these approaches to resolving franchise disputes, largely because these doctrines appear overly protective outside of the consumer context and because they cut too broadly, often resulting in an unenforceable contract. The essential element of inequality in franchising highlights another reason why these doctrines are inappropriate: They operate from the premise that the problem arises from the unequal bargaining power between franchisor and franchisee at the time the contract is ‘negotiated.’ However, the difficulties in franchising arise in the ongoing exercise of power in the gaps of the incomplete contract. While contracts could certainly be less one-sided, they could not be significantly less incomplete.<sup>242</sup>

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<sup>240</sup> See *Original Great Am. Chocolate Chip Cookie Co. v. River Valley Cookies, Ltd.*, 970 F.2d 273, 280 (7th Cir. 1992) (“Contract law imposes a duty . . . to avoid taking advantage of gaps in a [franchise agreement] in order to exploit the vulnerabilities that arise when contractual performance is sequential rather than simultaneous.”); see also *Interim Health Care of N. Ill., Inc. v. Interim Health Care, Inc.*, 225 F.3d 876, 884 (7th Cir. 2000) (holding that the implied covenant of good faith and fair dealing obligates a party who is vested with contractual discretion to “exercise that discretion reasonably and with proper motive,” and in a manner consistent with the reasonable expectations of the parties). Mr. Caruso represented one of the parties to the *Interim* case.

<sup>241</sup> See Gillian K. Hadfield, *Problematic Relations: Franchising and the Law of Incomplete Contracts*, 42 STAN. L. REV. 927 (1990); see also Brian E. Fox & Henry C. Su, *Franchise Regulation: Solutions In Search Of Problems*, 20 OKLA. CITY U. L. REV. 241 n.17 (1995) (“A [franchise agreement] is relational to the extent that the parties are incapable of reducing important terms of the arrangement to well-defined obligations. Such definitive obligations may be impractical because of inability to identify uncertain future conditions or because of inability to characterize complex adaptations adequately even when the contingencies themselves can be identified in advance.”).

<sup>242</sup> Hadfield, *supra* note 241, at n.262.

### 3. Efforts to Abolish Good Faith and Fair Dealing

The Ninth Circuit recognized, in *Chodos v. West Publishing Co.*, that the covenant of good faith and fair dealing makes discretionary promises real, and prevents the voiding of contracts for lack of mutuality.<sup>243</sup> Coming full circle, increasing efforts by franchisors to eliminate or reduce application of the doctrine of good faith and fair dealing to franchise agreements may spur unconscionability challenges.<sup>244</sup> If franchisors succeed in imposing waivers of the implied covenant, which some franchisors have attempted to do, franchisees may find that they are left without remedy for franchisor conduct that they find unfair when the franchise agreement does not explicitly prohibit that conduct. Nature abhors a vacuum, and so do most lawyers and judges. The absence of the implied covenant, or other “standards of care” by which to measure the adequacy of the franchisor’s performance of its duties under the franchise agreement, can make the franchisor’s promises illusory, and the enforceability of the franchise agreement may be called into question.

## VII. CONCLUSION

The doctrine of unconscionability appears to be in a state of flux, and it has yet to be determined what effect the recent California and Ninth Circuit cases will have on future decisions in those jurisdictions, and whether and how the impact of those decisions will extend elsewhere. However, the First Circuit’s recent *Kristian* decision, in which a court thousands of miles from California and the Ninth Circuit struck down provisions precluding class arbitration and damage provisions because they frustrated the vindication of statutory rights, should make all franchise lawyers sit up and take notice. Franchisee counsel may want to consider raising arguments long ago abandoned, and franchisor counsel should not be as dismissive of unconscionability attacks as they may have become. A new day dawning? It is too soon to tell, but we should all keep our eyes on the horizon.

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<sup>243</sup> 292 F.3d 992, 996-97 (9th Cir. 2002).

<sup>244</sup> See, e.g., Joseph Schumacher, *Exercise of Discretion -- Laws Affecting a Franchisor’s Exercise of Discretion and Avoiding Claims in the Exercise of Discretion*, INT’L FRANCHISE ASS’N ANNUAL LEGAL SYMPOSIUM, at 22 (May 2005). Mr. Schumacher is Ms. Appleby’s partner at Wiggin and Dana LLP.

## APPENDIX 1

See, e.g., N.H. Rev. Stat. Ann. § 357-C12, I (New Hampshire motor vehicle dealer law prohibiting conduct by manufacturers that is “arbitrary, in bad faith, or unconscionable”);

Illinois Motor Vehicle Franchise Act, 815 ILCS 710/4(b) (forbidding conduct that is “arbitrary, in bad faith or unconscionable”);

Ala. Code §§ 8-20-1 through 8-20-12 (Alabama Motor Vehicle Franchise Act); Ariz. Rev. Stat. Ann. §§ 44-1551 through 44-1560 (gasoline dealers/franchises);

Colo. Rev. Stat. §§ 12-6-101 and 12-6-102, 12-6-118(1) through 12-6-122, and 12-6-301 through 12-6-303 (automobile dealerships);

1992 Ill. Comp. Stat. Ann. 710/1 through 710/14 (Illinois Motor Vehicle Franchise Act);

Me. Rev. Stat. Ann. tit. 10, §§ 1361 through 1370 (power equipment, machinery, appliance franchises);

Mass. Gen. Laws ch. 93B, § 1 through 15 (motor vehicle dealers/franchises);

Mich. Comp. Laws § 445.903b(1) (Michigan Business Opportunity Law; incorporating the state Consumer Protection Act’s prohibition on unconscionable acts);

Mo. Rev. Stat. §§ 407.810 through 407.835 (Motor Vehicle Franchise Practices Act);

Ohio Rev. Code Ann. § 1334.03(B) (Business Opportunity Purchasers Protection Act; prohibiting “unconscionable act[s] or practice[s]” in connection with the sale or lease of a business opportunity plan);

Or. Rev. Stat. §§ 646.605(6), 646.605(9) & 646.607(1) (Oregon “Little FTC Act,” expressly covering offering, sale and rental of franchises, distributions and other business opportunities and prohibiting unconscionable tactics);

S.C. Code Ann. §§ 56-16-10 through 56-16-210 (motor vehicle franchises) & 39-6-10 through 180 (farm, construction, industrial and outdoor power equipment dealers/franchises);

Utah Code Ann. §§ 13-11-2(2), 13-11-3(2)(a) & 13-11-5 (Utah “Little FTC Act,” expressly covering business opportunities and prohibiting unconscionable acts and practices);

D.C. Code Ann. §§ 28-3901(7) & 28-3904(r) (District of Columbia “Little FTC Act,” expressly covering franchises and business opportunities, and prohibiting unconscionable terms in leases and contracts);

See *also* Uniform Franchise and Business Opportunities Act § 106, Bus. Franchise Guide (CCH) ¶ 3650 (withdrawn by National Conference of Commissioners of Uniform State Laws).

## APPENDIX 2

The terms “Little FTC Act” and “Baby FTC Act” are often used to refer to the state-by-state enactment of unfair trade practice legislation based on the Federal Trade Commission Act.

See ROBERT M. LANGER, ET AL., CONNECTICUT UNFAIR TRADE PRACTICES 1-2 (2003);

See also 16 H.R. Proc., Pt. 14, 1973 Sess. pp. 7321-24 (Ct. 1973) (remarks of Rep. Howard A. Newman, introducing the Connecticut Unfair Trade Practices Act for passage, and stating that the “bill is known as the baby FTC act.”). Mr. Langer is Ms. Appleby’s partner at Wiggin and Dana LLP.

States incorporating notions of unconscionability into their “Little FTC Acts” include:

Alabama (Ala. Code § 8-19-5(27));

Arkansas (Ark. Code Ann. § 4-88-107(a));

Florida (Fla. Stat. § 501.204(1)); Indiana (Ind. Code § 24-5-0.5-1(b)(1));

Kansas (Kan. Stat. Ann. § 50-627 (partially incorporating illustrative circumstances provided in Uniform Consumer Sales Practices Act § 4));

Kentucky (Ky. Rev. Stat. Ann. § 367.170(2) (providing that “unfair shall be construed to mean unconscionable”));

Michigan (Mich. Comp. Laws § 445.903);

Nebraska (Neb. Rev. Stat. §§ 87-303.01 & 87-303.07);

New Jersey (N.J. Stat. Ann. § 56:8-2);

New Mexico (N.M. Stat. §§ 57-12-2E & 57-12-3);

Ohio (Ohio Rev. Code Ann. § 1345.03 (partially incorporating illustrative circumstances provided in Uniform Consumer Sales Practices Act § 4));

Oregon (Or. Rev. Stat. §§ 646.605(9) & 646.607(1));

Texas (Tex. Code Ann. §§ 17.44(a), 17.45(5) & 17.50(a)(1)(B)(3)); Utah (Utah Code Ann. §§ 13-11-2(2) & 13-11-5) and the District of Columbia (D.C. Code § 28-3904(r) (partially incorporating illustrative circumstances provided in Uniform Consumer Sales Practices Act § 4)).

See also *Century 21 Real Estate Corp. v. Hometown Real Estate Co.*, 890 S.W.2d 118 (1994) (finding that franchisor committed unconscionable action under Texas DTPA in obtaining franchisee’s renewal agreement and then placing a second franchise in area);

*Bonanza Rests. v. Uncle Pete’s, Inc.*, 757 S.W.2d 445 (Tex. App. 1988) (franchisors conduct unconscionable under Texas DTPA based on franchisor’s failure to disclose substantial problems with existing franchise before purchase). In these Little FTC Acts, unconscionability is rarely defined and often treated as interchangeable with the more common terms “deceptive” and “unfair.” State Unfair Trade Practice Law (CCH) ¶ 1200 (John W. Arden, et al. eds., 2005).

### **APPENDIX 3**

See, e.g., *Jenkins v. First Am. Cash Advance of Georgia, LLC*, 400 F.3d 868 (11th Cir. 2005) (Georgia law), *cert. denied*, \_\_ U.S. \_\_, 126 S. Ct. 1457 (2006);

*Caley v. Gulfstream Aerospace Corp.*, 333 F. Supp. 2d 1367 (N.D. Ga. 2004), *aff'd*, 428 F.3d 1359 (11th Cir. 2005) (Georgia law), *cert. denied*, \_\_ U.S. \_\_, 126 S. Ct. 2020 (2006);

*Iberia Credit Bureau, Inc. v. Cingular Wireless LLC*, 379 F.3d 159 (5th Cir. 2004) (Louisiana law);

*Carter v. Countrywide Credit Indus., Inc.*, 362 F.3d 294 (5th Cir. 2004) (Texas law);

*Snowden v. CheckPoint Check Cashing*, 290 F.3d 631 (4th Cir. 2002) (Maryland and federal law);

*Hawkins v. Aid Ass'n for Lutherans*, 338 F.3d 801 (7th Cir. 2001) (Wisconsin law), *cert. denied*, 540 U.S. 1149 (2004);

*Johnson v. W. Suburban Bank*, 225 F.3d 366 (3d Cir. 2000) (federal law);

*Copeland v. Katz*, No. 05-73370, 2005 WL 3163296 (E.D. Mich. Nov. 28, 2005) (Michigan law);

*Storie v. Household, Int'l, Inc.*, No. 03-40268-FDS, 2005 WL 3728718 (D. Mass Sept. 22, 2005) (Massachusetts law);

*Delta Funding Corp. v. Harris*, 396 F. Supp. 2d 512 (D.N.J. 2004) (New Jersey law), *question of class-arbitration provision's unconscionability certified to New Jersey Supreme Court by 426 F.3d 671 (3d Cir. 2005)*, *cert. accepted by 185 N.J. 255, provision held not unconscionable by \_\_ A.2d \_\_, 2006 WL 2277984 (N.J. Aug. 9, 2006)*;

*Household Bank, F.S.B. v. JFS Group*, No. 2:01cv1405-A, 2004 U.S. Dist. LEXIS 28011 (M.D. Ala. Oct. 14, 2004) (Alabama law);

*Adams v. Am. Residential Servs., L.L.C.*, No. 02-410 (JDB), 2003 U.S. District LEXIS 26478 (D.D.C. May 8, 2003).

Some state courts have, however, accepted the argument that class action arbitration waivers are, or may be, unconscionable.

See, e.g., *Lytle v. CitiFinancial Servs., Inc.*, 810 A.2d 643 (Pa. Super. Ct. 2002);

*Powertel, Inc. v. Bexley*, 743 So.2d 570 (Fla. Dist. Ct. App 1999) (finding arbitration clause unconscionable where it would require arbitration of claim brought under Florida Little FTC Act without the availability of class arbitration).

#### **APPENDIX 4**

See, e.g., *Ticknor v. Choice Hotels Int'l, Inc.*, 265 F.3d 931, 939-40 (9th Cir. 2001) (applying Montana law, finding that standardized form franchise agreement, drafted by franchisor, which franchisee was forced to accept or reject, was an adhesion contract);

*Elec. & Magneto Serv. Co. v. AMBAC Int'l Corp.*, 941 F.2d 660, 663 n.3 (8th Cir. 1991) (“[T]he Missouri Legislature created a legislative presumption that franchisees are in an inferior bargaining position with respect to franchisors and thus are entitled to protection from the oppressive use of the franchisor’s superiority . . . . [A]llowing franchisors to terminate franchise agreements with less than ninety-days notice is an oppressive use of bargaining strength.”);

*Am. Nursing Care of Toledo, Inc. v. Leisure*, 609 F. Supp. 419, 431 (N.D. Ohio 1984) (“Franchise relationships present inherent dangers which are common in adhesion contracts and in business contracts between parties in unequal bargaining positions . . . . All of the contracts under consideration are, as is typical in such agreements, highly favorable to the franchisor while offering the franchisees little protection.”) (citing Harold Brown, *FRANCHISING: REALITIES AND REMEDIES* §§ 2.01, 2.03 (1981));

*Vishal Hospitality, LLC v. Choice Hotels Int'l, Inc.*, 907 So.2d 80, 82, (La. Ct. App. 2005), *abrogated by* *Aguillard v. Auction Mgmt. Corp.*, 908 So.2d 1 (La. 2005) (arbitration clause in franchise agreement is “adhesionary” when franchisor reserves for itself the right to litigate various matters, including collection of monies owed to it under the franchise agreement, but requiring franchisee to arbitrate all disputes arising under the franchise agreement.);

*Cf. Kubis & Perszyk Assocs., Inc. v. Sun Microsystems Inc.*, 680 A.2d 618, 626 (N.J. 1996) (forum selection clauses presumptively invalid unless franchisor can prove that franchise agreement was not thrust on franchisee on a take-it or leave-it basis).

“The factors involved in characterizing a contract as adhesive vary greatly among the states; . . . .” Kaufman, *supra* note 48, at 104 n.54 (2002).

In broad terms, a contract of adhesion is “a contract to which one of the parties must either ‘adhere’ entirely or refuse altogether . . . . The hallmark of the adhesion contract, and its alleged evil, is that the purveyor of such a contract is in the position for one reason or another to refuse to bargain, to put the other party to a take-it-or-leave it option.” Leff, *supra* note 10, at 504-06.

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Mr. Caruso has briefed and argued many appeals in the Seventh Circuit Court of Appeals and the Illinois Appellate Courts, and has filed Amicus Curiae briefs in the United States Supreme Court on behalf of franchising associations, and decisions in his cases have been the subject of commentary by the American Bar Association (Forum on Franchising) and the *Chicago Daily Law Bulletin*.

Recognized as a "Legal Eagle" by *Franchise Times*, Mr. Caruso has been a frequent author and lecturer on trial technique and franchise law for the American Bar Association (Forum on Franchising), the International Franchise Association, the Asian American Hotel Owners Association, the Association of Certified Fraud Examiners, and the American Association of Franchisees & Dealers. In addition, he has published numerous articles that have appeared in *Franchise Times* and other publications. He has served on the Board of Advisors for Catholic Charities of Chicago since 1997.

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