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**EFFECTIVE AND FAILED STRATEGIES  
TO COMPEL/AVOID ARBITRATION**

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## I. INTRODUCTION

Arbitration is a common, but somewhat controversial, form of dispute resolution in the franchise world. Proponents of arbitration will point to the ability to control aspects of the dispute resolution process, the efficiency of the proceedings, and the finality of the award.<sup>1</sup> Conversely, opponents will point to the ever increasing costs and timelines involved in arbitration, as well as the lack of class or group actions and preclusion of juries.<sup>2</sup> The result of this split in opinions on arbitration has led to an increasing number of challenges to avoid the arbitration process, or to force parties to participate. This paper will first examine multiple legal strategies that have recently been effective in either compelling or avoiding the arbitration process, before turning to a discussion of some practical guidance for how to avoid these enforcement disputes.

## II. ARBITRABILITY – WHAT DOES IT MEAN AND WHO DECIDES

### A. Some Background

The Federal Arbitration Act (FAA or the Act) was enacted close to a century ago to “reverse the longstanding judicial hostility to arbitration agreements.”<sup>3</sup> Since then, the question of arbitrability and, in particular, who decides that question has been frequently contested both because of an absence of clear statutory guidance and lingering judicial reluctance—some would say hostility—to enforcing arbitration agreements.

In understanding the issue of arbitrability, the starting point is, of course, the language of the FAA.<sup>4</sup> Section 2, the “primary substantive provision of the [FAA],”<sup>5</sup> provides that arbitration agreements “shall be valid, irrevocable, and enforceable, save upon such grounds as exist at law or in equity for the revocation of any contract.”<sup>6</sup> Section 3 and 4 of the Act generally vest the trial courts with the responsibility for determining whether a dispute is arbitrable. Under Section 3, the court shall stay a proceeding “*upon being satisfied that the issue involved in such suit or proceeding is referable to arbitration under such an agreement.*”<sup>7</sup> And under Section 4,

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<sup>1</sup> See Julianne Lusthaus, Mary Leslie Smith & Quentin R. Wittrock, *Is Franchising Abandoning Arbitration? Current Trends in Arbitrating Franchise Disputes*, ABA 32nd ANNUAL FORUM ON FRANCHISING, W-11 at 4-7 (2009).

<sup>2</sup> See *Id.*

<sup>3</sup> *Gilmer v. Interstate/Johnson Lane Corp.*, 500 U.S. 20, 24 (1991); see also *Dean Witter Reynolds, Inc. v. Byrd*, 470 U.S. 213, 218 (1985) (“By its terms, the Act leaves no place for the exercise of discretion by a district court, but instead mandates that district courts *shall* direct the parties to proceed to arbitration on issues as to which an arbitration agreement has been signed.”); *Moses H. Cone Memorial Hosp. v. Mercury Constr. Corp.*, 460 U.S. 1, 24-25 (1983) (“any doubts concerning the scope of arbitrable issues should be resolved in favor of arbitration, whether the problem at hand is the construction of the contract language itself or an allegation of waiver, delay, or a like defense to arbitrability.”).

<sup>4</sup> Although there was and remains some disagreement about the intended scope of the FAA, it is now well-accepted that the FAA applies to all agreements “involving [interstate] commerce” irrespective of whether the underlying dispute is in federal or state court. See generally 9 U.S.C. § 2; *Allied-Bruce Terminix Cos. v. Dobson*, 513 U.S. 265 (1995); *Southland Corp. v. Keating*, 465 U.S. 1 (1984). And because of the Supreme Court’s expansive interpretation of what constitutes interstate commerce and the Commerce Clause itself, this necessarily means that the FAA applies to virtually all arbitration agreements. Given this, the focus of this article is on arbitration issues arising under the FAA and its application in federal court.

<sup>5</sup> *Moses H. Cone*, 460 U.S. at 24.

<sup>6</sup> 9 U.S.C. § 2.

<sup>7</sup> 9 U.S.C. § 3 (emphasis added).

the court shall grant a petition to compel arbitration “upon being satisfied that the making of the agreement for arbitration or the failure to comply therewith is not in issue.”<sup>8</sup>

## **B. The Key Supreme Court Cases**

The application of the FAA turned out to be more complicated than perhaps anticipated in many respects, two of which are particularly relevant here—first, who should decide the question of whether an agreement which includes an arbitration clause was the product of mistake, fraud or duress rendering the agreement invalid, and second, whether the district court or arbitrator should decide whether a matter is subject to arbitration.<sup>9</sup>

The Supreme Court confronted the first issue in *Prima Paint Corp. v. Flood & Conklin Manufacturing Co.*<sup>10</sup> Prima Paint sought to avoid arbitration of its claims against Flood & Conklin (F&C), arguing it was fraudulently induced into entering into the agreement with F&C and, therefore, the parties’ agreement to arbitrate was invalid.<sup>11</sup> The Court framed the issue for consideration as “whether the federal court or an arbitrator is to resolve a claim of ‘fraud in the inducement’ . . . where there is no evidence that the contracting parties intended to withhold that issue from arbitration.”<sup>12</sup>

Although the case arose in the context of a Section 3 motion to stay, the Court observed that Section 4 requires the court to decide whether the “*agreement for arbitration . . . is not in issue[.]*” but does not “permit the federal court to consider claims of fraud in the inducement of the *contract generally*.”<sup>13</sup> The Court reasoned that “it is inconceivable that Congress intended the rule to differ depending upon which party to the arbitration agreement first invokes the assistance of a federal court.”<sup>14</sup> In a 6-3 decision, the Court held that the question of whether the agreement itself was induced by fraud was for the arbitrator to decide because “a federal court may consider only issues relating to the making and performance of the agreement to arbitrate.”<sup>15</sup> In reaching this decision, the Court concluded that it was “honor[ing] the plain meaning of the statute but also the unmistakably clear congressional purpose that the arbitration procedure, when selected by the parties to a contract, be speedy and not subject to delay and obstruction in the courts.”<sup>16</sup>

The Court’s holding was not without criticism; indeed, Justice Black writing for the minority in *Prima Paint* characterized it as “fantastic [] that the legal issue of a contract’s voidness because of fraud is to be decided by persons designated to arbitrate factual controversies arising out of a valid contract between the parties.”<sup>17</sup> But the Court said what it said and the lower courts generally understood that when a party attacked the validity of a so-

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<sup>8</sup> 9 U.S.C. § 4 (emphasis added).

<sup>9</sup> See David Horton, *Arbitration About Arbitration*, 70 STAN. L. REV. 363, 379-83 (2018).

<sup>10</sup> 388 U.S. 395 (1967).

<sup>11</sup> *Id.* at 398.

<sup>12</sup> *Id.* at 396-97.

<sup>13</sup> *Id.* at 403-404 (emphasis added).

<sup>14</sup> *Id.* at 404.

<sup>15</sup> *Id.*

<sup>16</sup> *Id.*

<sup>17</sup> *Id.* at 407.

called “container” agreement, but not the arbitration provision within that agreement, the arbitrator and not the court decided the validity question. The Supreme Court reaffirmed this general principle in *Buckeye Check Cashing, Inc. v. Cardegna*.<sup>18</sup> Relying on its decision in *Prima Paint*, the Court held that “as a matter of substantive federal arbitration law, an arbitration provision is severable from the remainder of the contract. . . . [and] unless the challenge is to the arbitration clause itself, the issue of the contract’s validity is considered by the arbitrator in the first instance.”<sup>19</sup>

The other arbitrability question—who decides whether the parties have agreed to submit the matter to arbitration—has proved to be thornier and more nuanced. It involves a number of potential issues, including (i) what law should be applied; (ii) whether the arbitration provision is valid; (iii) whether the subject matter of the dispute falls within the arbitration provision; (iv) whether a party has waived its right to arbitrate; and (v) whether third parties are bound by the provision. The Supreme Court has weighed in on these and other issues involving arbitration on many occasions. The below discussion addresses the key relevant Supreme Court cases.

In *Moses H. Cone Memorial Hospital v. Mercury Construction Corp.*, the Court addressed the preliminary question of what law should apply to determining a question of arbitrability, holding that the court is to make this determination by applying the “federal substantive law of arbitrability, applicable to any arbitration agreement within the coverage of the Act.”<sup>20</sup> And that law requires “that questions of arbitrability must be addressed with a healthy regard for the federal policy favoring arbitration. . . . The [FAA] establishes that, as a matter of federal law, any doubts concerning the scope of arbitrable issues should be resolved in favor of arbitration, whether the problem at hand is the construction of the contract language itself or an allegation of waiver, delay, or a like defense to arbitrability.”<sup>21</sup> Several years later, in *Mitsubishi Motors Corp. v. Soler Chrysler-Plymouth, Inc.*, the Court confirmed these general principles and further added that “as with any other contract, the parties’ intentions control, but those intentions are generously construed as to issues of arbitrability.”<sup>22</sup>

One year later, the Supreme Court addressed the issue of who decides the arbitrability question in *AT & T Technologies, Inc. v. Communications Workers of America* in the context of determining whether a grievance filed by a Union was covered by the arbitration provision in its collective-bargaining agreement with AT & T.<sup>23</sup> In finding that it was not, the Court held that “[u]nless the parties clearly and unmistakably provide otherwise, the question of whether the parties agreed to arbitrate is to be decided by the court, not the arbitrator.”<sup>24</sup>

The Supreme Court returned to this question in *First Options of Chicago, Inc. v. Kaplan*, which involved an agreement between a stock-clearing firm and investment company.<sup>25</sup> First Options initiated arbitration against the owner of the investment company and his wife. The

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<sup>18</sup> 546 U.S. 440, 449 (2006).

<sup>19</sup> *Id.* at 445-46.

<sup>20</sup> 460 U.S. at 24; see also *Mitsubishi Motors Corp. v. Soler Chrysler-Plymouth, Inc.*, 473 U.S. 614, 626 (1985).

<sup>21</sup> *Moses H. Cone*, 460 U.S. at 24-25.

<sup>22</sup> 473 U.S. at 626.

<sup>23</sup> 475 U.S. 643 (1986).

<sup>24</sup> *Id.* at 649 (citing *United Steelworkers of Am. v. Warrior & Gulf Nav. Co.*, 363 U.S. 574, 582-83 (1960), and *John Wiley & Sons, Inc. v. Livingston*, 376 U.S. 543, 546 (1964)) (other citations omitted).

<sup>25</sup> 514 U.S. 938, 940 (1995).

couple contended that they had not agreed to arbitration and contested the arbitrators' power to decide that issue. In holding that the question of "who has the primary power to decide arbitrability" turns upon what the parties agreed about *that* matter" (i.e., the parties' intent), the Court noted that "the law treats silence or ambiguity about 'who (primarily) should decide arbitrability' differently from the way it treats silence or ambiguity about the question 'whether a particular merits-related dispute is arbitrable because it is within the scope of a valid arbitration agreement.'"<sup>26</sup> As to the later question, the Court reiterated that "any doubts concerning the scope of arbitrable issues should be resolved in favor of arbitration."<sup>27</sup> However, as to the former question—who decides—the Court, quoting its earlier decision in *AT & T Technologies*, held that courts "should *not* assume that the parties agreed to arbitrate arbitrability unless there is 'clea[r] and unmishtakabl[e]' evidence that they did so."<sup>28</sup>

Seven years later, the Court tackled the issue of what constitutes a "question of arbitrability" in *Howsam v. Dean Witter Reynolds, Inc.*<sup>29</sup> In a short decision, the Court noted that although "any potentially dispositive gateway question [may be] a 'question of arbitrability,' for its answer will determine whether the underlying controversy will proceed to arbitration on the merits[,] . . . [t]he Court's case law, however, makes clear that, for purposes of applying the interpretive rule, the phrase 'question of arbitrability' has a far more limited scope."<sup>30</sup> The Court further explained that the "phrase [is] applicable in the kind of narrow circumstance where contracting parties would likely have expected a court to have decided the gateway matter, where they are not likely to have thought that they had agreed that an arbitrator would do so, and, consequently, where reference of the gateway dispute to the court avoids the risk of forcing parties to arbitrate a matter that they may well not have agreed to arbitrate."<sup>31</sup>

Thus, a question "whether the parties are bound by a given arbitration clause" is a "question of arbitrability" for a court to decide, as is a "[question] whether an arbitration clause in a concededly binding contract applies to a particular type of controversy."<sup>32</sup> Without specifically embracing the nomenclature, the Court quoted one of the comments to the Revised Uniform Arbitration Act of 2000 (RUAA), which called such matters "issues of *substantive arbitrability*."<sup>33</sup>

The Court went on to state that, conversely, "the phrase 'question of arbitrability' [is] *not* applicable in other kinds of general circumstance where parties would likely expect that an arbitrator would decide the gateway matter."<sup>34</sup> Thus, "*procedural*" questions which grow out of the dispute and bear on its final disposition" are presumptively *not* for the judge, but for an arbitrator, to decide."<sup>35</sup> The Court provided some examples of the sorts questions that it viewed

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<sup>26</sup> *Id.* at 943-45 (emphasis in original).

<sup>27</sup> *Id.* at 945 (quoting *Mitsubishi Motors*, 473 U.S. at 626 (1985)) (other citations omitted).

<sup>28</sup> *Id.* at 944 (alterations in original) (emphasis added) (quoting *AT & T Techs.*, 475 U.S. at 649).

<sup>29</sup> 537 U.S. 79 (2002).

<sup>30</sup> *Id.* at 83 (citing *First Options*, 514 U.S. at 942).

<sup>31</sup> *Id.* at 83-84.

<sup>32</sup> *Id.* at 84 (citations omitted).

<sup>33</sup> *Id.* at 85 (quoting RUAA § 6, comment 2, 7 U.L.A., at 12-13 (Supp.2002)) (emphasis added).

<sup>34</sup> *Id.* (emphasis in original).

<sup>35</sup> *Id.* (emphasis added) (internal citations omitted).

as procedural, including (i) whether conditions precedent to arbitration have been satisfied,<sup>36</sup> and (ii) “allegation[s] of waiver, delay, or a like defense to arbitrability.”<sup>37</sup>

In 2010, in *Rent-a-Center West, Inc. v. Jackson*, the Supreme Court again returned to the issue of who decides arbitrability, this time in the context of an employment-discrimination lawsuit filed against Rent-a-Center by a former employee.<sup>38</sup> As a condition of his employment, Jackson and Rent-a-Center signed a Mutual Agreement to Arbitrate, which included two separate relevant provisions. The first required the parties to arbitrate all “past, present or future” disputes arising out of Jackson’s employment.<sup>39</sup> The second was a comprehensive delegation clause, which provided that “[t]he Arbitrator, and not any federal, state, or local court or agency, shall have exclusive authority to resolve any dispute relating to the interpretation, applicability, enforceability or formation of this Agreement including, but not limited to any claim that all or any part of this Agreement is void or voidable.”<sup>40</sup>

Rent-a-Center moved to compel arbitration. Although Jackson opposed on the ground the underlying agreement to arbitrate was unconscionable, he did not specifically attack the delegation clause. The district court granted Rent-a-Center’s motion, finding that the delegation clause vested the arbitrator with exclusive authority to determine whether the arbitration agreement was enforceable and, because Jackson had failed to challenge the delegation clause, such issue was for the arbitrator to decide.<sup>41</sup> The Ninth Circuit reversed on the issue of who should decide whether the arbitration agreement was enforceable, holding the “threshold issue of unconscionability is for the court” to decide.<sup>42</sup>

The Supreme Court came to a different conclusion, holding that the delegation provision was “an additional, antecedent agreement” and “the FAA operates on this additional arbitration agreement just as it does on any other.”<sup>43</sup> Thus, “the basis of challenge [must] be directed specifically to the agreement to arbitrate [at issue] before the court will intervene.”<sup>44</sup> And because the arbitration agreement at issue was the delegation provision and Jackson had failed to specifically challenge it (rather than the underlying agreement to arbitrate), the Court reversed the Ninth Circuit leaving it to the arbitrator to determine whether the arbitration agreement was unconscionable.<sup>45</sup>

Taken together, the Court’s holdings from these and other cases can be distilled to the following basic principles: (i) “any doubts concerning the scope of arbitrable issues should be resolved in favor of arbitration”;<sup>46</sup> (ii) “gateway” questions of arbitrability are questions of “whether the parties have agreed to arbitrate or whether their agreement covers a particular

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<sup>36</sup> *Id.* at 84-85.

<sup>37</sup> *Id.* (quoting *Moses H. Cone*, 460 U.S. at 24-25).

<sup>38</sup> 561 U.S. 63 (2010).

<sup>39</sup> *Id.* at 65.

<sup>40</sup> *Id.* at 66.

<sup>41</sup> *Id.*

<sup>42</sup> *Jackson v. Rent-a-Center West, Inc.*, 581 F.3d 912, 918-20 (2009).

<sup>43</sup> *Rent-a-Center*, 561 U.S. at 70.

<sup>44</sup> *Id.* at 71.

<sup>45</sup> *Id.* at 72-76.

<sup>46</sup> *Moses H. Cone*, 460 U.S. at 24-25.

controversy”;<sup>47</sup> (iii) federal law governs the question of arbitrability absent a clear agreement to the contrary;<sup>48</sup> (iv) questions of arbitrability are to be decided by the court,<sup>49</sup> unless (v) there is “clear and unmistakable” evidence the parties agreed that questions of arbitrability are to be decided by the arbitrator,<sup>50</sup> which (vi) turns upon the parties’ intent;<sup>51</sup> and (vii) a party contesting the delegation of the arbitrability question to an arbitrator must direct its attack to the delegation provision itself rather than the arbitration provision in general.<sup>52</sup>

### **C. Frequently Litigated Arbitrability Issues**

#### **1. Can State Law Apply to the Arbitrability Determination?**

As discussed above, in almost all instances, and absent a clear agreement to the contrary, federal law will govern the question of arbitrability.<sup>53</sup> What contractual language is sufficiently clear to supplant federal arbitrability law with state law is somewhat unclear and has been the subject of many cases. Much of the confusion stems from a misreading of the Supreme Court’s holdings in *Volt Information Sciences, Inc. v. Board of Trustees of Leland Stanford Junior University*.<sup>54</sup>

In *Volt*, the Court was faced with the specific question of whether § 1281.2(c) of the California Arbitration Act, which permits a court to stay arbitration pending the resolution of related litigation involving a third party, was preempted by the FAA, which does not include a similar provision. The parties’ contract included provisions requiring that all disputes arising out of the contract were subject to arbitration and that the contract would be governed by the law of “the place where the Project is located.”<sup>55</sup> The state court of appeals affirmed the trial court’s order granting a stay of arbitration pending the completion of third-party litigation, finding that the choice-of-law clause effectively incorporated the California rules of arbitration, including § 1281.2(c), and that § 1281.2(c) was not preempted by the FAA.<sup>56</sup> The U.S. Supreme Court affirmed, holding that the FAA does not “prevent[] the enforcement of agreements to arbitrate under different rules than those set forth in the [FAA] itself,”<sup>57</sup> because “[t]here is no federal policy favoring arbitration under a certain set of procedural rules.”<sup>58</sup> Indeed, where “the parties have agreed to abide by state rules of arbitration, enforcing those rules according to the terms of the agreement is fully consistent with the goals of the FAA.”<sup>59</sup> Importantly, and although often lost in translation, *Volt*’s holding was limited to questions of procedure and did *not* address the

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<sup>47</sup> *Rent-a-Center*, 561 U.S. at 68-69.

<sup>48</sup> *Mitsubishi Motors*, 473 U.S. 614 at 626 (1985) (quoting *Moses H. Cone*, 460 U.S. 1, 24).

<sup>49</sup> *AT & T Techs.*, 475 U.S. at 649.

<sup>50</sup> *Id.*

<sup>51</sup> *First Options*, 514 U.S. at 943-45.

<sup>52</sup> *Rent-a-Center*, 561 U.S. at 69, 71.

<sup>53</sup> *Mitsubishi Motors*, 473 U.S. at 626.

<sup>54</sup> 489 U.S. 468 (1989).

<sup>55</sup> *Id.* at 470.

<sup>56</sup> *Id.* at 471-72.

<sup>57</sup> *Id.* at 479.

<sup>58</sup> *Id.* at 476.

<sup>59</sup> *Id.* at 479.

question of if, or when, state law may supplant federal law for purposes of determining arbitrability.<sup>60</sup>

Since *Volt*, and notwithstanding its narrow holding, parties have often cited it as support for the proposition that a general choice-of-law provision is sufficient to supplant federal law as to the *substantive* question of arbitrability.<sup>61</sup> Frequently relying on the Supreme Court's holding in *Mastrobuono v. Shearson Lehman Hutton, Inc.*,<sup>62</sup> courts have routinely rejected such arguments, finding that a general choice-of-law provision does *not* constitute the requisite clear and unmistakable evidence sufficient to override the default application of federal law to the arbitrability issue.<sup>63</sup> The rationale for this as explained by the Ninth Circuit is that "[l]ike the question of who should decide arbitrability, the question of what law governs arbitrability is 'rather arcane,'" and, therefore, "[i]n negotiating an agreement, parties are just as unlikely to give thought to the applicable arbitrability law as they are to give thought to the person determining arbitrability."<sup>64</sup> Accordingly, federal law is presumed to apply. However, as a number of courts have suggested, contractual language stating that state or some other law applies specifically to issues of arbitrability should suffice to overcome the presumption.<sup>65</sup>

Notably, when an agreement includes both a choice-of-law provision and an arbitration provision, parties cannot invoke state arbitrability laws where doing so would undercut the

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<sup>60</sup> See *Brennan v. Opus Bank*, 796 F.3d 1125, 1129 (9th Cir. 2015) ("*Volt* dealt with a dispute about whether the parties' agreement to conduct arbitration in accordance with the *procedural* rules of the [CAA] was enforceable. . . . [T]he parties here . . . dispute which *substantive* law governs the arbitrability question. *Volt's* holding does not address this question.").

<sup>61</sup> See, e.g., *id.*; *Cape Flattery Ltd. v. Titan Maritime, LLC*, 647 F.3d 914, 921 (9th Cir. 2011); *Nat'l Union Fire Ins. Co. of Pittsburgh, Pa. v. Belco Petroleum Corp.*, 88 F.3d 129, 134 (2nd Cir. 1996); *Sea Bowld Marine Grp, LDC v. Oceanfast Pty., Ltd.*, 432 F. Supp. 2d 1305, 1311-12 (S.D. Fla. 2006); *Anderson Plant v. Batzer Constr., Inc.*, No. 2:13-CV-02109-KJM-CMK, 2014 WL 800293, at \*3 (E.D. Cal. Feb. 27 2014).

<sup>62</sup> 514 U.S. 52 (1995).

<sup>63</sup> *Brennan*, 796 F.3d at 1129 (finding that federal law of arbitrability applies because "[w]hile the Employment Agreement is clear that California's procedural rules, rights, and remedies apply *during* arbitration, it says nothing about whether California's law governs the question whether certain disputes are to be submitted to arbitration in the first place"); *Cape Flattery*, 647 F.3d at 921 ("courts should apply federal arbitrability law absent 'clear and unmistakable evidence' that the parties agreed to apply non-federal arbitrability law" and finding the agreement ambiguous as to whether the choice-of-law provision applied to issues of arbitrability); *PaineWebber Inc. v. Bybyk*, 81 F.3d 1193, 1200 (2nd Cir. 1996) ("Therefore, a choice-of-law provision, when accompanied by an arbitration provision such as in the Agreement, 'encompass[es] substantive principles that New York courts would apply, *but not* . . . special rules limiting the authority of the arbitrators.'"); *Sea Bowld Marine Grp.*, 432 F. Supp. 2d at 1311-12 (general choice-of-law provision applied to the substantive law to be used, but did not apply to the threshold issue of arbitrability); *Chloe Z Fishing Co., Inc. v. Odyssey Re (London) Ltd.*, 109 F. Supp. 2d 1236, 1252 (S.D. Cal. 2000) (holding that for agreements covered by the FAA, the FAA provides an "'overriding basis' for why the law under which the case 'arises' . . . must apply to the question of whether these parties agreed to arbitrate their disputes"); *Anderson Plant v. Batzer Constr., Inc.*, 2014 WL 800293, at \*3 (considering choice-of-law provision calling for the application of California law, "including California law . . . governing arbitration proceedings" and applying federal law where the agreement was "silent as to whether California law 'also applies to determine whether a given dispute is arbitrable in the first place'").

<sup>64</sup> *Cape Flattery*, 647 F.3d at 921.

<sup>65</sup> See *Brennan*, 796 F.3d at 1129 ("it does not expressly state that California law governs the question of *arbitrability*"); *Meadows v. Dickey's Barbecue Rests. Inc.*, 144 F.Supp.3d 1069, 1076 (N.D. Cal. 2015) ("As a preliminary matter, the Court applies federal arbitrability law because the Franchise Agreement's choice-of-law provision does not expressly state that Texas law governs the question of arbitrability."); *Anderson Plant v. Batzer Construction, Inc.*, 2014 WL 800293, at \*3 (applying federal law because the agreement was "silent as to whether California law also applies to whether a particular dispute is arbitrable in the first place").

enforceability of the parties' agreement to arbitrate.<sup>66</sup> Indeed, the Supreme Court has repeatedly affirmed that the FAA displaces *conflicting* state laws.<sup>67</sup> This general principle was applied in two oft-cited Supreme Court cases involving large franchise systems.<sup>68</sup>

Thus, although it is possible that state law or the law of a foreign jurisdiction could apply to the arbitrability determination, in practice this is an unlikely scenario. And if this is what both of the parties actually want, which also seems unlikely, then the arbitration agreement should clearly say so.

## 2. Delegation by Incorporation of Arbitration Rules

Courts have uniformly found that a provision incorporating the rules of an arbitral organization constitutes clear and unmistakable evidence the parties agreed to arbitrate arbitrability provided such rules clearly permit the arbitrator to determine the scope of his or her jurisdiction.<sup>69</sup> This principle applies even though there are some syntactic difference in the rules of the arbitral organizations: (i) AAA ("The arbitrator shall have the power to rule on his or her own jurisdiction, including any objections with respect to the existence, scope, or validity of the arbitration agreement or to the arbitrability of any claim or counterclaim.");<sup>70</sup> (ii) JAMS ("Jurisdictional and arbitrability disputes, including disputes over the formation, existence, validity, interpretation or scope of the agreement under which Arbitration is sought, and who are proper Parties to the Arbitration, shall be submitted to and ruled on by the Arbitrator. The Arbitrator has the authority to determine jurisdiction and arbitrability issues as a preliminary matter.");<sup>71</sup> and (iii) United Nations Commission on International Trade Law (UNCITRAL) ("The arbitral tribunal shall have the power to rule on its own jurisdiction, including any objections with

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<sup>66</sup> See, e.g., *Preston v. Ferrer*, 552 U.S. 346, 359 (2008) ("When parties agree to arbitrate all questions arising under a contract, the [FAA] supersedes state laws lodging primary jurisdiction in another forum, whether judicial or administrative.").

<sup>67</sup> See, e.g., *Allied-Bruce*, 513 U.S. at 272 (Alabama law invalidating written pre-dispute arbitration agreements); *Perry v. Thomas*, 482 U.S. 483, 489 (1987) (California labor code provision permitting action to recover wages "without regard to the existence of any private agreement to arbitrate").

<sup>68</sup> *Doctor's Assocs., Inc. v. Casarotto*, 517 U.S. 681, 688 (1996) (Montana's notice law regarding arbitration provisions "places arbitration agreements in a class apart from 'any contract', and singularly limits their validity. The State's prescription is thus inconsonant with, and is therefore preempted by, the federal law."); *Southland*, 465 U.S. at 15 ("In creating a substantive rule applicable in state as well as federal courts [the FAA], Congress intended to foreclose state legislative attempts to undercut the enforceability of arbitration agreements. [Therefore], § 31512 of the California Franchise Investment Law violates the Supremacy Clause.).

<sup>69</sup> See, e.g., *Brennan*, 796 F.3d at 1130-31; *Petrofac, Inc. v. DynMcDermott Petroleum Operations Co.*, 687 F.3d 671, 675 (5th Cir. 2012); *Republic of Arg. v. BG Grp. PLC*, 665 F.3d 1363, 1371 (D.C. Cir. 2012), *rev'd on other grounds*, 572 U.S. 25 (2014); *Fallo v. High-Tech Inst.*, 559 F.3d 874, 878 (8th Cir. 2009); *Awuah v. Coverall N. Am., Inc.*, 554 F.3d 7, 10-12 (1st Cir. 2009); *Qualcomm Inc. v. Nokia Corp.*, 466 F.3d 1366, 1373 (Fed. Cir. 2006); *Terminix Int'l Co. v. Palmer Ranch LP*, 432 F.3d 1327, 1332 (11th Cir. 2005); *Contec Corp. v. Remote Solution Co.*, 398 F.3d 205, 208 (2d Cir. 2005).

<sup>70</sup> AM. ARBITRATION ASS'N, COMMERCIAL ARBITRATION RULES r. 7(a) (2016); see, e.g., *Brennan*, 796 F.3d at 1130-31 (incorporation of AAA Rules constitutes clear and unmistakable evidence delegating arbitrability question to arbitrator); *Terminix*, 432 F.3d at 1332 (same); *Contec*, 398 F.3d at 208 (same); *RW Dev., L.L.C. v. Cunningham Grp. Architecture, P.A.*, 562 F. App'x. 224, 226 (5th Cir. 2014) (same).

<sup>71</sup> JAMS, JAMS COMPREHENSIVE ARBITRATION RULES r. 11(b) (2014); see, e.g., *Belnap v. Lasis Healthcare*, 844 F.3d 1272, 1281-84 (10th Cir. 2017) ("[B]y incorporating the JAMS Rules into the Agreement, Dr. Belnap and SLRMC clearly and unmistakably agreed to submit arbitrability issues to an arbitrator."); *Simply Wireless, Inc. v. T-Mobile US, Inc.*, 877 F.3d 522, 527-28 (4th Cir. 2017) (same), *petition for certiorari filed*, No. 17-1423, --- S.Ct. --- (U.S. Apr. 9, 2018); *Cooper v. WestEnd Capital Mgmt., L.L.C.*, 832 F.3d 534, 546 (5th Cir. 2016) (same); *Wynn Resorts, Ltd. v. Atl.-Pac. Capital, Inc.*, 497 F. App'x. 740, 742 (9th Cir. 2012) (same).

respect to the existence or validity of the arbitration agreement. For that purpose, an arbitration clause that forms part of a contract shall be treated as an agreement independent of the other terms of the contract.).<sup>72</sup>

In sum, given the overwhelming weight of authority that incorporating the rules of an arbitral organization establishes the required clear and unmistakable intent the parties agreed to delegate the arbitrability issues to the arbitrator, an argument to the contrary is all but certain to fail.

### **3. Potential Conflicts re the Issue of Delegation**

Courts regularly confront arguments that other contractual provisions conflict with or somehow contradict an express delegation provision or implicit delegation by incorporation of AAA Rules, etc. so as to render it unclear whether the parties actually intended to delegate the arbitrability question to an arbitrator. This issue arises in a variety of contexts.

For example, in *Vargas v. Delivery Outsourcing, LLC*, the parties' agreement included a clause expressly delegating arbitrability to the arbitrator, but the same section of the agreement also provided that "[i]f any provision of this Agreement or portion thereof is held to be unenforceable *by a court of law or equity*, said provision or portion thereof shall not prejudice the enforceability of any other provision or portion of the same provision. . . ."<sup>73</sup> The district court found that the issue of delegation was rendered ambiguous by the phrase "*by a court of law or equity*," because this "language is necessary only if questions concerning arbitrability are *not* resolved by the arbitrator."<sup>74</sup> Accordingly, the court held that the agreement could not be read as "providing a 'clear and unmistakable' delegation to the arbitrator."<sup>75</sup>

In *O'Connor v. Uber Technologies, Inc.*, another district court in the Northern District of California reached a similar result.<sup>76</sup> The parties' agreement included a delegation clause requiring that any "disputes arising out of or relating to the interpretation or application of this Arbitration Provision, including the enforceability, revocability or validity of the Arbitration Provision or any provision of the Arbitration Provision" be decided by the arbitrator.<sup>77</sup> However, the agreement also included a general jurisdiction provision providing that "any disputes, actions, claims or causes of action . . . shall be subject to the exclusive jurisdiction of the state and federal courts located in the City and County of San Francisco, California" and that "[i]f any provision of the Agreement is held to be invalid or unenforceable, such provision shall be struck and the remaining provisions shall be enforced to the fullest extent under law."<sup>78</sup> The court found that because the general jurisdiction provision "specifically contemplates the ability of the court to find a provision unenforceable," there was a "direct contradiction with the delegation

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<sup>72</sup> UNITED NATIONS COMMISSION ON INT'L TRADE LAW, ARBITRATION RULES art. 23, para. 1 (2013); see, e.g., *Chevron Corp. v. Republic of Ecuador*, 795 F.3d 200, 207-08 (D.C. Cir. 2015) (arbitrability issue delegated to arbitrators to decide based on incorporation of UNCITRAL Rules); *Oracle Am., Inc. v. Myriad Grp. A.G.*, 724 F.3d 1069, 1074-75 (9th Cir. 2013) ("We see no reason to deviate from the prevailing view that incorporation of the UNCITRAL arbitration rules is clear and unmistakable evidence that the parties agreed the arbitrator would decide arbitrability.").

<sup>73</sup> No. 15-CV-03408-JST, 2016 WL 946112, at \*2 (N.D. Cal. Mar. 14, 2016) (emphasis in original).

<sup>74</sup> *Id.* at 6 (emphasis in original).

<sup>75</sup> *Id.* at 7.

<sup>76</sup> 150 F. Supp. 3d 1095 (N.D. Cal. 2015).

<sup>77</sup> *Id.* at 1099.

<sup>78</sup> *Id.* at 1101.

clause that states only the arbitrator decides the arbitration agreement's enforceability." As a result, the court found there was no clear and unmistakable delegation.<sup>79</sup>

Other courts, including a recent decision from the Ninth Circuit, have harmonized arguably conflicting provisions in finding the required clear and unmistakable intent. For example, in *Mohamed v. Uber Technologies, Inc.*, the Ninth Circuit overturned a district court's ruling that was similar to *O'Connor*, holding that the conflicts were "artificial," and the venue provision was not ambiguous because "[n]o matter how broad the arbitration clause, it may be necessary to file an action in court to enforce an arbitration agreement."<sup>80</sup>

The Eighth Circuit came to a similar conclusion in *Awuah v. Coverall North America, Inc.*<sup>81</sup> The parties' franchise agreements incorporated AAA's Rules (including Rule 7, which provides "[t]he arbitrator shall have the power to rule on his or her own jurisdiction, including any objections with respect to the existence, scope or validity of the arbitration agreement") and provided that "the arbitrator . . . shall not alter or otherwise reform the terms of this agreement" and other language to the same effect.<sup>82</sup> The agreements also included a severability clause allowing other provisions to survive if "a court of competent jurisdiction" invalidates a provision.<sup>83</sup> The Eighth Circuit found that this was "too thin a basis for concluding that the agreements' language 'evinces an intent to allow questions of arbitrability to be decided by a court,'" and that Rule 7 was "about as 'clear and unmistakable' as language can get."<sup>84</sup>

In a recent case involving a Subway franchisee, *Doctor's Associates, Inc. v. Tripathi*, the district court rejected the franchisees' arguments that the severability and jury waiver provisions conflicted with the delegation provision.<sup>85</sup> The court found that the purported conflict was "artificial" because "it is plausible that situations could arise in which a Court could review the arbitral panel's determination on enforceability when, for example, deciding a post-award motion to vacate."<sup>86</sup>

And in another recent franchise case, *Capelli Enterprises, Inc. v. Fantastic Sams Salons Corp.*, a district court from the Northern District of California was similarly unpersuaded by the franchisee's argument that provisions in the franchise agreement resulted in an ambiguity as to the parties' intent on the issue of delegating arbitrability.<sup>87</sup> Plaintiffs argued that the portion of the arbitration clause in which the parties consented to the "jurisdiction of any appropriate court

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<sup>79</sup> *Id.* at 1102.

<sup>80</sup> 848 F.3d 1201, 1209 (9th Cir. 2016) (citation omitted).

<sup>81</sup> 554 F.3d 7, 11 (1st Cir. 2009).

<sup>82</sup> *Id.*

<sup>83</sup> *Id.*

<sup>84</sup> *Id.*; see also *Oracle*, 724 F.3d at 1077 (rejecting argument that agreement governed by the UNCITRAL rules regarding issues of arbitrability was made ambiguous by the following paragraph which stated rules that differed from UNCITRAL rules); *Fallo*, 559 F.3d at 879 (8th Cir. 2009) ("[T]he students argue that the reference to 'court costs' conflicts with a clear and unmistakable intent to arbitrate. However, after participating in arbitration, a party may seek to have the arbitrator's order confirmed, modified or vacated in a court, thereby incurring court costs. Thus, the governing law provision's reference to 'court costs' is not inconsistent with a clear and unmistakable intent to arbitrate.") (internal citation omitted).

<sup>85</sup> No. 16-CV-00562-JCH, 2016 WL 7634464, at \*17 n.13 (D. Conn. Nov. 3, 2016.).

<sup>86</sup> *Id.* at \*18.

<sup>87</sup> No. 16-CV-03401-EJD, 2016 WL 4492588, at \*5 (N.D. Cal. Aug. 26, 2016).

to enforce the provisions of this section and/or to confirm any award rendered by the panel of arbitrators,” “manifestly contradicts’ any delegation of arbitrability.”<sup>88</sup> In finding that the agreement was consistent with the delegation of arbitrability, the court noted that the provision “only allows the court the ability to enforce the provision by compelling a claim to arbitration, or to confirm any subsequent award.”<sup>89</sup>

As these and other cases illustrate, there are many potential scenarios (at least in theory) in which language in a franchise agreement *may* conflict with a clear delegation clause. Given this, a franchisor should carefully review its agreements with this issue in mind to minimize such risk. On the other hand, a franchisee seeking to have the court decide the arbitrability question may be able to disprove the required clear and unmistakable intent by pointing to contractual provisions that arguably conflict to some degree.

#### **4. Does the Sophistication of the Parties Matter?**

For the most part, arguments that a party is unsophisticated have not been successful in overcoming the general rule that incorporation of the AAA rules and the rules of similar organization constitutes clear and unmistakable evidence of the parties’ intent to delegate the arbitrability determination to the arbitrator.<sup>90</sup> Thus, even in circumstances where one of the parties was plainly less sophisticated, courts have found such incorporation was clear and unmistakable evidence of the parties’ intent to decide arbitrability in arbitration.<sup>91</sup> In the Ninth Circuit, however, the question is less certain. In *Brennan v. Opus Bank*, although the court held that the incorporation of the AAA Rules constituted “clear and unmistakable” evidence of the parties’ intent to arbitrate arbitrability, it left open the question of whether its holding extended to unsophisticated parties or consumer contracts:

Our holding today should not be interpreted to require that the contracting parties be sophisticated or that the contract be “commercial” before a court may conclude that incorporation of the AAA rules constitutes “clear and unmistakable” evidence of the parties’ intent. Thus, our holding does not foreclose the possibility that this rule could also apply to unsophisticated parties or to consumer contracts. Indeed, the vast majority of the circuits that hold that incorporation of the AAA rules constitutes clear and unmistakable evidence of the parties’ intent do so without explicitly limiting that holding to sophisticated parties or to commercial contracts.<sup>92</sup>

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<sup>88</sup> *Id.* at \*6.

<sup>89</sup> *Id.*

<sup>90</sup> See, e.g., *Fallo*, 559 F.3d at 878 (“[A]lthough High-Tech may have been in a superior bargaining position, the contract terms were clear, and a reasonable person could expect that disputes would be arbitrated.”).

<sup>91</sup> See *Cubria v. Uber Techs., Inc.*, 242 F. Supp. 3d 541, 549 (W.D. Tex. 2017) (“the incorporation of the AAA Rules constitutes clear and unmistakable evidence the parties agreed to arbitrate arbitrability, regardless of the sophistication of the parties.”); see also *Davis v. USA Nutra Labs*, 303 F. Supp. 3d 1183, 1197-98 (D.N.M. 2018) (in a product liability action involving Garcinia Cambog tablets purchased online, incorporation of JAMS Rules into the arbitration agreement showed the parties clearly and unmistakably agreed to submit arbitrability issues to an arbitrator) *Hobzek v. HomeAway.com, Inc.*, No. A-16-CA-1058-SS, 2017 WL 476748, at \*1 (W.D. Tex. Feb. 3, 2017) (same result in the civil rights context); *Alvarado v. Conn Appliances, Inc.*, No. 1:16-CV-464-LY, 2016 WL 6834020, at \*2 (W.D. Tex. Nov. 17, 2016) (same result in a consumer class action).

<sup>92</sup> *Brennan*, 796 F.3d at 1130-31.

Since *Brennan*, district courts within the Ninth Circuit have reached different results.<sup>93</sup> Notably, at least one district court refused to extend the general rule in the franchise context, finding that the franchisees were “unsophisticated.” In *Meadows v. Dickey’s Barbecue Restaurants, Inc.*, a district court from the Northern District of California concluded that the franchisees “were not ‘sophisticated’, and that the rule announced in *Brennan* and *Oracle* [did] not apply.”<sup>94</sup> However, in *Capelli Enterprises, Inc. v. Fantastic Sams Salon Corp.*, another district court from the Northern District of California reached the opposite conclusion with respect to a franchisee in another franchise system.<sup>95</sup> There, the court found that the franchisees “possessed the ‘modicum of sophistication’ necessary to understand the import of the Agreement’s terms, including the incorporation of the AAA rules.”<sup>96</sup>

District courts from other circuits have bypassed the issue of a franchisee’s relative sophistication, instead finding that the issue of sophistication was irrelevant.<sup>97</sup> However, in *Awuah v. Coverall North America, Inc.*, although the court held that sophistication of parties was not a relevant consideration, the First Circuit commented that “[i]f the matter were completely open in this circuit, we are not certain of the outcome.”<sup>98</sup>

Although there is some room for argument, at least in the Ninth Circuit (and especially in the California district courts), a franchisees’ claimed lack of sophistication is unlikely to in and of itself to establish a lack of clear and unmistakable intent to delegate the arbitrability question to an arbitrator.

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<sup>93</sup> *Compare Cordas v. Uber Techs., Inc.*, 228 F. Supp. 3d 985, 992 (N.D. Cal. 2017) (“[N]early every decision in the Northern District of California . . . has consistently found effective delegation of arbitrability regardless of the sophistication of the parties.”), *Diaz v. Intuit, Inc.*, No. 15-CV-01778-EJD, 2017 WL 4355075, at \*3 (N.D. Cal. Sept. 29, 2017) (“courts in this district have consistently found that the reference to AAA rules evinces a clear and unmistakable intent to delegate arbitrability to an arbitrator, regardless of the sophistication of the parties.”), *Seaman v. Private Placement Capital Notes II, LLC*, No. 16-CV-00578-BAS-DHB, 2017 WL 1166336, at \*4 (S.D. Cal. Mar. 29, 2017) (“[T]here is no requirement that the parties be sophisticated or that the contract be a commercial contract before a court may conclude that incorporation of the AAA Rules is a clear and unmistakable evidence of intent to arbitrate arbitrability.”), *appeal docketed*, No. 17-55599 (9th Cir. Apr. 28, 2017), and *Galen v. Redfin Corp.*, No. 14-CV-05229-TEH, 2015 WL 7734137, at \*7 (N.D. Cal. Dec. 1, 2015) (finding licensed real estate agent plaintiffs possessed “at least a modicum of sophistication”), *with Galilea, LLC v. AGCS Marine Ins. Co.*, No. CV-15-84-BLG-SPW, 2016 WL 1328920, at \*3 (D. Mont. Apr. 5, 2016) (“incorporation of the AAA rules into the insurance policy is not clear and unmistakable evidence of delegation”), *rev’d in relevant part and remanded*, *Galilea, LLC v. AGCS Marine Ins. Co.* 879 F.3d 1052, 1061 (9th Cir. 2018), and *Tompkins v. 23andMe, Inc.*, No. 13-CV-05682-LHK, 2014 WL 2903752, at \*11-12 (N.D. Cal. June 25, 2014) (incorporation of AAA rules insufficient to establish delegation in a contract between a DNA testing service and individual consumers); *cf. Appel v. Concierge Auctions, LLC*, No. 17-CV-02263-BAS-MDD, 2018 WL 1773479, at \*5 (S.D. Cal. Apr. 13, 2018) (although “mindful of the concerns reflected by several courts, which emphasize that ‘an inexperienced individual untrained in the law’ is less likely to be reasonably expected to understand the incorporation of arbitrator rules into an arbitration agreement,” court “satisfied with [p]laintiffs’ level of sophistication to the extent they can understand the provisions within this arbitration agreement”).

<sup>94</sup> 144 F. Supp. 3d at 1078-79.

<sup>95</sup> No. 16-CV-03401-EJD, 2016 WL 4492588, at \*4 (N.D. Cal. Aug. 26, 2016).

<sup>96</sup> *Id.* at \*5 (citing *Galen v. Redfin Corp.*, 2015 WL 7734137, at \*6).

<sup>97</sup> *See, e.g., Doctor’s Assocs., Inc. v. Tripathi*, No. 16-CV-00562-JCH, 2016 WL 7634464, at \*18 (D. Conn. Mar. 27, 2017) (rejecting defendant’s sophistication argument because they failed to cite any 2nd Circuit case in support and did not appear to be unsophisticated, but instead “seasoned business people who have run more than 30 Subway franchises . . . .”); *Barber v. Gloria Jean’s Gourmet Coffees Franchising Corp.*, No. 01-CV1027-P, 2002 WL 87349, at \*4 (N.D. Tex. Jan. 16, 2002) (in granting motion to compel arbitration granted, court dismissed plaintiffs’ argument they were unsophisticated).

<sup>98</sup> 554 F.3d 7, 8, 10-11 (1st Cir. 2009).

## 5. What if the Arbitrability Claim is “Wholly Groundless”?

In cases where the parties clearly and unmistakably intended to delegate the power to decide arbitrability to an arbitrator, some courts have engaged in a secondary analysis—considering whether the assertion of arbitrability is “wholly groundless” or, in other words, whether “a party’s assertion that a claim falls within an arbitration clause is frivolous or otherwise illegitimate.”<sup>99</sup>

The circuits have split on the question of whether the FAA permits a court to decline to enforce an agreement delegating questions of arbitrability to an arbitrator if the court concludes the claim is wholly groundless. Four courts of appeals—the fourth, fifth, sixth and federal circuits—have held that courts may resolve gateway disputes over arbitrability, even in the presence of a delegation provision, if the court determines the underlying claim for arbitration is “wholly groundless.”<sup>100</sup> On the other hand, two courts of appeals—the tenth and eleventh circuits—have held that disputes about arbitrability must be decided by an arbitrator whenever the parties have delegated that issue to an arbitrator, regardless of the merits of the arbitrability issue.<sup>101</sup>

The wholly groundless doctrine has been applied in the franchise context with varying results. Some courts that have applied the doctrine have compelled arbitration,<sup>102</sup> whereas other courts have refused, finding that the underlying claims are not arbitrable and, therefore, the assertion of arbitrability is “wholly groundless.”<sup>103</sup>

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<sup>99</sup> See, e.g., *Simply Wireless*, 877 F.3d at 528-29.

<sup>100</sup> See *Qualcomm*, 466 F.3d at 1371 (holding that if a delegation clause delegates the authority to rule on arbitrability to an arbitrator, “then the court should perform a second, more limited inquiry to determine whether the assertion of arbitrability is ‘wholly groundless’”); *Turi v. Main St. Adoption Servs. LLP*, 633 F.3d 496, 511 (6th Cir. 2011) (“even where the parties expressly delegate to the arbitrator the authority to decide the arbitrability of the claims related to the parties’ arbitration agreement, this delegation applies only to claims that are at least *arguably* covered by the agreement”); *Douglas v. Regions Bank*, 757 F.3d 460, 464 (5th Cir. 2014) (finding even where there is a delegation provision, “the court must ask whether the averment that the claim falls within the scope of the arbitration agreement is wholly groundless”); *Simply Wireless*, 877 F.3d at 528 (“a district court must give effect to a contractual provision clearly and unmistakably delegating questions of arbitrability to an arbitrator, ‘unless it is clear that he claim of arbitrability is wholly groundless’”).

<sup>101</sup> See *Belnap*, 844 F.3d at 1286-87 (declining to adopt the wholly groundless exception and noting that it “appears to be in tension with language of the Supreme Court’s arbitration decisions—in particular, with the Court’s express instruction that when parties have agreed to submit an issue to arbitration, courts must compel that issue to arbitration without regard to its merits”); *Jones v. Waffle House, Inc.*, 866 F.3d 1257, 1268-70 (11th Cir. 2017) (declining to adopt the wholly groundless exception reasoning that it “runs against the Supreme Court’s unambiguous instruction that lower courts may not ‘delve into the merits of the dispute’” and adding “concerns about efficiency cannot justify adopting the wholly groundless exception”).

<sup>102</sup> See, e.g., *Gonzalez v. Coverall N. Am., Inc.*, No. 16-CV-02287-JGB, 2017 WL 4676576, at \*4-5 (C.D. Cal. April 13, 2017) (applying the wholly groundless doctrine and compelling arbitration where the language of the delegation provision demonstrated the parties’ clear and unmistakable intent to arbitrate and the assertion of arbitrability was not wholly groundless); *Interdigital Tech. Corp. v. Pegatron Corp.*, No. 15-CV-02584-LHK, 2016 WL 234433, at \*5-10 (N.D. Cal. Jan. 20, 2016) (compelling arbitration after finding (1) the parties clearly and unmistakably intended to delegate arbitrability to the arbitrator by incorporating the AAA rules, and (2) Interdigital’s claims or arbitrability were not wholly groundless).

<sup>103</sup> See, e.g., *Stockade Cos., LLC v. Kelly Rest. Grp., LLC*, No. 17-CV-143-RP, 2017 WL 1968328, at \*3 (W.D. Tex. May 11, 2017) (refusing to compel arbitration, finding Stockade’s claims were not arbitrable); *Mr. Rooter LLC v. Akhoian*, No. 16-CV-00433-RP, 2017 WL 5240886, at \*2 (W.D. Tex. Jan. 30, 2017) (refusing to compel arbitration, finding the underlying dispute did not fall within the arbitration agreement and thus the assertion of arbitrability was wholly groundless).

In June 2018, the U.S. Supreme Court granted certiorari on the question of “whether the FAA permits a court to decline to enforce an agreement delegating questions of arbitrability to an arbitrator if the court concludes the claim of arbitrability is “wholly groundless” and the related circuit split.<sup>104</sup> An answer to this question—likely no—will presumably be forthcoming next Supreme Court term.

### III. SEEKING PRELIMINARY INJUNCTIVE RELIEF IN COURT v. ARBITRATION

Despite the many perceived benefits of arbitration, the practical availability of emergency injunctive relief has for many years clearly not been one of them. It invariably takes several months, and sometimes many months, for an arbitrator (or arbitrators) to be appointed after an arbitration has been commenced. Such delay is, of course, not conducive to obtaining a preliminary injunction to avoid irreparable harm. For this reason, courts have routinely agreed that district courts retained jurisdiction to consider requests for preliminary injunctive relief to preserve the status quo pending the arbitration of the parties’ dispute.<sup>105</sup>

Recently, however, many of the major arbitral organizations have amended their rules to provide for emergency relief prior to the appointment of the arbitrator(s). How these rules will be applied in practice and whether they will obviate the need to seek injunctive relief from district courts remains to be determined. A brief overview of the new rules and the few cases that address some of the issues raised by these new rules follows.

#### A. Overview of Arbitration Rules Providing for Emergency Relief

##### 1. American Arbitration Association

Effective October 1, 2013, AAA amended its Commercial Arbitration Rules so that its previously optional Rules for Emergency Measures of Protection would, with certain modifications, apply to all arbitration clauses or agreements entered into after that date.<sup>106</sup> Under Rule 38, a party may seek emergency injunctive relief as follows: (i) the opposing party must be provided with written notice regarding the nature of and reasons for the requested

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<sup>104</sup> See *Henry Schein, Inc. v. Archer & White Sales*, No. 17-1272. --- S.Ct. ---, 2018 WL 1280843 (Mem) (U.S. Jun. 25, 2018).

<sup>105</sup> See, e.g., *Benihana, Inc. v. Benihana of Tokyo, LLC*, 784 F.3d 887, 894-95 (2d Cir. 2015) (“Where the parties have agreed to arbitrate a dispute, a district court has jurisdiction to issue a preliminary injunction to preserve the status quo pending arbitration.”); *Toyo Tire Holdings of Americas Inc. v. Conti Tire N. Am., Inc.*, 609 F.3d 975, 981 (9th Cir. 2010) (“[A] district court may issue interim injunctive relief on arbitrable claims if interim relief is necessary to preserve the status quo and the meaningfulness of the arbitration process.”); *Performance Unlimited, Inc. v. Questar Publishers, Inc.*, 52 F.3d 1373, 1380 (6th Cir. 1995); (“[A] grant of preliminary injunctive relief pending arbitration is particularly appropriate and furthers the Congressional purpose behind the Federal Arbitration Act, ‘where the withholding of injunctive relief would render the process of arbitration meaningless or a hollow formality because an arbitral award, at the time it was rendered ‘could not return the parties substantially to the status quo ante.’” (citations omitted)); *Ortho Pharm. Corp. v. Amgen, Inc.*, 882 F.2d 806, 812 (3d Cir. 1989) (“[W]e hold that a district court has the authority to grant injunctive relief in an arbitrable dispute, provided that the traditional prerequisites for such relief are satisfied.”); *Teradyne, Inc. v. Mostek Corp.*, 797 F.2d 43, 47-51 (1st Cir.1986) (“We hold, therefore, that a district court can grant injunctive relief in an arbitrable dispute pending arbitration, provided the prerequisites for injunctive relief are satisfied. We believe this approach reinforces rather than detracts from the policy of the Arbitration Act . . . .”); *Merrill Lynch, Pierce, Fenner & Smith, Inc. v. Bradley*, 756 F.2d 1048, 1050-55 (4th Cir.1985) (“We do not believe that Congress would have enacted a statute intended to have the sweeping effect of stripping the federal judiciary of its equitable powers in all arbitrable commercial disputes without undertaking a comprehensive discussion and evaluation of the statute’s effect. Accordingly, we conclude that the language of § 3 [of the FAA] does not preclude a district court from granting one party a preliminary injunction to preserve the status quo pending arbitration.”).

<sup>106</sup> AM. ARBITRATION ASS’N, COMMERCIAL ARBITRATION RULES r. 38 (2016); see <https://www.adr.org/Rules>.

relief;<sup>107</sup> (ii) a single emergency arbitrator will be appointed within one business day of AAA's receipt of the application;<sup>108</sup> (iii) the opposing party will have one business day to challenge the appointment of the emergency arbitrator;<sup>109</sup> (iv) as soon as possible, but within two days of being appointed, the emergency arbitrator will establish a schedule for considering the application, which "shall provide a reasonable opportunity" for all parties to be heard;<sup>110</sup> (v) the emergency arbitrator has the authority to rule on his/her own jurisdiction and resolve any disputes regarding the applicability of Rule 38;<sup>111</sup> (vi) if satisfied that "immediate and irreparable loss or damage [will] result in the absence of emergency relief, and that [the moving] party is entitled to such relief," the emergency arbitrator may enter an interim order or award granting such relief;<sup>112</sup> (vii) the emergency arbitrator retains jurisdiction until the arbitrator is appointed;<sup>113</sup> (viii) the party seeking relief may be required to provide "appropriate security;"<sup>114</sup> (ix) a party's request for interim relief addressed to "a judicial authority shall not be deemed incompatible with this rule, the agreement to arbitrate or a waiver of the right to arbitrate;"<sup>115</sup> and (x) the emergency arbitrator shall initially apportion the costs of the application for emergency relief, "subject to the power of the tribunal to determine finally the apportionment of such costs."<sup>116</sup>

The International Centre for Dispute Resolution (ICDR), the international branch of AAA, has adopted similar rules.<sup>117</sup>

## 2. JAMS

JAMS Rule 2 was amended effective July 1, 2014 and is virtually identical to AAA Rule 38 with three exceptions.<sup>118</sup> *First*, the new rule applies to all "[a]rbitrations filed and served" after July 1, 2014.<sup>119</sup> This is potentially significant in that, on its face, the new rule would apply retroactively to arbitration agreements that were entered into *before* July 1, 2014, which raises questions about how a party could have intended that requests for emergency injunctive relief be decided in arbitration when there was no meaningful procedure to accomplish that prior to July 1, 2014. *Second*, the emergency arbitrator will be "promptly" appointed, which "[i]n most cases . . . will be done within 24 hours."<sup>120</sup> And *third*, the rule does

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<sup>107</sup> *Id.*, r. 38(b).

<sup>108</sup> *Id.*, r. 38(c).

<sup>109</sup> *Id.*

<sup>110</sup> *Id.*, r. 38(d).

<sup>111</sup> *Id.*

<sup>112</sup> *Id.*, r. 38(e).

<sup>113</sup> *Id.*, r. 38(f).

<sup>114</sup> *Id.*, r. 38 (g)

<sup>115</sup> *Id.*, r. 38(h).

<sup>116</sup> *Id.*, r. 38(i).

<sup>117</sup> See INTERNATIONAL CENTRE FOR DISPUTE RESOLUTION, ICDR ARBITRATION RULES Art. 6 (2016); see <http://internationalarbitrationlaw.com/about-arbitration/international-arbitration-rules/icdr-arbitration-rules/icdr-arbitration-rules/>

<sup>118</sup> JAMS, JAMS COMPREHENSIVE ARBITRATION RULES & PROCEDURES R. 2 (2014); see <https://www.jamsadr.com/rules-comprehensive-arbitration>.

<sup>119</sup> *Id.*, r. 2(c).

<sup>120</sup> *Id.*, r. 2(c) (ii).

not expressly authorize the emergency arbitrator to apportion the costs associated with the application for emergency relief.

### **3. Int'l Institute for Conflict Prevention and Resolution (CPR)**

The International Institute for Conflict Prevention and Resolution (CPR) has also recently adopted rules permitting a party to seek interim relief on an expedited basis.<sup>121</sup> Like JAMS Rule 2, CPR Rule 14 is substantially similar to AAA Rule 38. The only notable differences are that the timing for the appointment of the “special arbitrator” is less certain<sup>122</sup> and there is no specific timing by which the special arbitrator must determine the procedure to be followed and the nature of the proceedings.<sup>123</sup>

#### **B. Interplay Between The Courts and Arbitral Forums Regarding Interim Relief**

There is a notable paucity of case law addressing the interplay between (i) arbitration provisions, (ii) carve-out provisions allowing parties to seek injunctive relief in court, and (iii) the new arbitration rules providing for emergency interim relief. However, a few recent decisions illustrate some of the thorny issues that courts are likely to confront in the near future.

In a perfunctory opinion, a U.S. District Court for the Northern District of California directly confronted what may soon become a common issue—whether the new emergency interim relief rules effectively obviate the need for district courts to issue injunctive relief to preserve the status quo pending arbitration. In *SMART Technologies ULC v. Rapt Touch Ireland Ltd.*, the court declined to exercise its discretion to issue a temporary restraining order based on the availability of the emergency arbitration rules of an unidentified arbitral organization even though the contract at issue specifically allowed the parties to seek emergency relief from a court in certain circumstances.<sup>124</sup> The court found that SMART had failed to demonstrate “an urgent need for a federal court to exercise its discretion to award interim relief,” because it had “offered no explanation why a federal court (rather than an arbitrator) should adjudicate the request for emergency relief” given the availability of such relief in arbitration.<sup>125</sup>

In *Grasso Enterprises, LLC v. CVS Health Corp.*, the U.S. District Court for the Western District of Texas addressed the threshold question of whether it or an arbitrator should decide Grasso’s motion for a preliminary injunction.<sup>126</sup> The parties’ agreement included a general arbitration provision, as well as a carve-out provision allowing the parties to “seek preliminary injunctive relief to halt or prevent a breach of [the parties’ agreement] in any state or federal

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<sup>121</sup> INT’L INST. FOR CONFLICT PREVENTION AND RESOLUTION, 2014 CPR RULES FOR ADMINISTERED ARBITRATION OF INTERNATIONAL DISPUTES r. 14 (2014); see <https://www.cpradr.org/resource-center/rules/international-other/arbitration/international-administered-arbitration-rules>.

<sup>122</sup> *Id.*, r. 14.5 (“To the extent practicable, CPR shall appoint the special arbitrator within one business day of CPR’s receipt of the application for interim measures under this Rule.”).

<sup>123</sup> *Id.*, r. 14.8 (“The special arbitrator shall determine the procedure to be followed, which shall include, whenever possible, reasonable notice to, and an opportunity for hearing (either in person, by teleconference or other appropriate means) for all affected parties. The special arbitrator shall conduct the proceedings as expeditiously as possible . . .”).

<sup>124</sup> 197 F. Supp. 3d 1204, 1205 (N.D. Cal. 2016).

<sup>125</sup> *Id.* The court was not impressed by SMART’s lawyer’s explanation that he believed a federal court would be more likely to issue a TRO automatically. *Id.*

<sup>126</sup> 143 F. Supp. 3d 530 (2015).

court of law.”<sup>127</sup> CVS moved to dismiss and compel arbitration, while Grasso moved for a preliminary injunction.<sup>128</sup> After determining that the parties had agreed to arbitrate arbitrability and ordering all claims be sent to the arbitrator, the court declined to rule on Grasso’s motion for preliminary injunction, holding “[a]ny sort of injunctive relief should be contemplated by the arbitrator.”<sup>129</sup> In so finding, the court disregarded Grasso’s argument that the ‘carve-out provision allowed either party to seek injunctive relief outside the arbitration.<sup>130</sup> Instead, the court agreed with the Eighth Circuit that “the judicial inquiry requisite to determine the propriety of injunctive relief necessarily would inject the court into the merits of issues more appropriately left to the arbitrator.”<sup>131</sup> Indeed, the court found that since both parties agreed to arbitrate arbitrability, an arbitrator, and not the court, should decide whether the issue underlying the claim for preliminary injunctive relief is within the scope of the arbitration agreement or is covered by the carve-out provision.<sup>132</sup>

Another district court in Texas reached a similar result. In *A&C Discount Pharmacy, L.L.C. v. Caremark, L.L.C.*, the court considered whether it or the arbitrator should decide if a party’s request for preliminary injunctive relief was arbitrable. In this case, the plaintiff sued for injunctive relief and declaratory relief.<sup>133</sup> The parties’ agreement included an arbitration provision which provided that all disputes between the parties be arbitrated and incorporated the AAA rules.<sup>134</sup> The defendant moved to compel arbitration, arguing that the AAA rules permitted it to seek preliminary injunctive relief in court.<sup>135</sup> The court held that the arbitration agreement was enforceable and that the parties’ dispute fell within the scope of that agreement.<sup>136</sup> Thus, the sole issue was who—between the court and the arbitrator—should decide the request for injunctive relief where the court had already determined that the underlying claims were subject to arbitration.<sup>137</sup> Plaintiff argued that the AAA emergency rules regarding arbitration permitted it to seek injunctive relief before the court.<sup>138</sup> The court disagreed, finding that the express incorporation of the AAA Rules into the arbitration agreement constituted clear and unmistakable evidence that the parties agreed to arbitrate arbitrability and thus the arbitrator, not the court, should rule on who has the primary power to decide whether the request for injunctive relief was arbitrable.<sup>139</sup>

In *Gold v. Maurer*, plaintiffs filed a demand for arbitration with AAA pursuant to an arbitration provision in the parties’ agreement.<sup>140</sup> After filing their demand for arbitration,

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<sup>127</sup> *Id.* at 534.

<sup>128</sup> *Id.* at 533.

<sup>129</sup> *Id.* at 542-43.

<sup>130</sup> *Id.* at 543.

<sup>131</sup> *Id.* at 543 (quoting *Merrill Lynch, Pierce, Fenner & Smith, Inc. v. Hovey*, 726 F.2d 1286, 1292 (8th Cir. 1984)).

<sup>132</sup> *Id.* at 544.

<sup>133</sup> No. 16-CV-0264-D, 2016 WL 3476970 (N.D. Tex. June 27, 2016).

<sup>134</sup> *Id.* at \*2.

<sup>135</sup> *Id.*

<sup>136</sup> *Id.* at \*3.

<sup>137</sup> *Id.*

<sup>138</sup> *Id.*

<sup>139</sup> *Id.* at \*6.

<sup>140</sup> 251 F. Supp. 3d 127 (D.D.C. 2017).

plaintiffs filed a motion in the U.S. District Court for the District of Columbia seeking a temporary restraining order.<sup>141</sup> The court concluded that such relief was not warranted, in part because plaintiffs had failed to seek the appointment of an emergency arbitrator under AAA Rule 38.<sup>142</sup> In particular, the court found that the availability of the emergency appointment process under Rule 38 was relevant to the irreparable harm and balancing of the equities factors<sup>143</sup> In addressing the public policy factor, the court also concluded that “rather than facilitating the arbitral process, the order that Plaintiffs seek would likely act as a short-circuit, requiring the Court to essentially adjudicate the merits of Plaintiffs’ defamation claim . . . . And were it to do so, the Court would in effect make crucial determinations as to the merits of the defamation claim that Plaintiffs must, as they concede, pursue through arbitration. That result would be at odds with the federal policy in favor of arbitration.”<sup>144</sup>

Although these cases illustrate the uncertain landscape surrounding issues of arbitrability as they relate to requests for interim relief, they also highlight what may become a growing trend of courts deferring to arbitrators on both the preliminary issue of who decides the arbitrability question with respect to requests for emergency injunctive relief and the ultimate decision of whether such relief is warranted. Whether this is a good thing from the perspective of either or both franchisors and franchisees remains to be seen.

#### **IV. ARBITRATION AGREEMENTS AND NON-SIGNATORIES**

Franchise agreements, like many other agreements (*e.g.*, employment agreements, purchase-sale agreements and service agreements), nearly all contain an arbitration clause. And, there are often attempts to compel or avoid arbitration, by raising issues including who may assert the arbitration clause, with one of those situations being when a non-signatory to the franchise agreement can compel/avoid arbitration.

There are two primary fact patterns involving compelling arbitration and non-signatories – (1) when the non-signatory attempts to compel arbitration against a signatory to the franchise agreement, and (2) when a signatory to the franchise agreement attempts to compel arbitration against a non-signatory to the franchise agreement.

In general, most non-signatories to a franchise agreement are able to compel arbitration against a signatory (*e.g.*, a non-signatory officer of the franchisor can compel arbitration as to the franchisee), however, most signatories to a franchise agreement may not compel arbitration against a non-signatory.

##### **A. A Brief History**

Prior to 2009, there was no clear federal guidance as to when (or if) a non-signatory to a contractual arbitration provision can compel arbitration. There were a couple of United States Supreme Court decisions that made it less than certain whether a non-signatory could compel

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<sup>141</sup> *Id.* at 130.

<sup>142</sup> *Id.* at 135-37.

<sup>143</sup> *Id.*

<sup>144</sup> *Id.* at 137.

arbitration.<sup>145</sup> However, in 2009 the U.S. Supreme Court clarified the scope of the FAA as to non-signatories in *Arthur Anderson LLP v. Carlisle*.<sup>146</sup>

*Arthur Anderson* (not a franchise case), involved individual investors who took the advice of Arthur Anderson and formed LLCs to invest in another company to reduce tax liability. After the IRS ruled that the arrangement was an illegal tax shelter, the investors sued Arthur Anderson and the company in which they invested. Arthur Anderson sought to compel arbitration via the agreements signed by the investors and the other company.<sup>147</sup>

The U.S. Supreme Court held that a non-signatory to a contract may bind a signatory to arbitrate a dispute when “traditional principals of state law allow a contract to be enforced by or against nonparties to the contract through assumption, piercing the corporate veil, alter ego, incorporation by reference, third party beneficiary theories, waiver and estoppel.”<sup>148</sup> The holding opened the door to the enforcement of arbitration clauses by non-signatories, to be determined on a state-by-state, case-by-case basis.

## **B. When a Non-Signatory Seeks to Compel Arbitration Against a Signatory**

In the wake of the *Arthur Anderson* decision, when considering whether a non-signatory can compel arbitration against a signatory, the court “must expressly consider whether the relevant state contract law recognizes the particular principle as a ground for enforcing contracts [by or] against third parties.”<sup>149</sup>

Thus, when a non-signatory attempts to compel arbitration, a state-by-state analysis must ensue to determine what contract law principles apply to the franchise agreement at issue with respect to third party enforcement. However, there are two universal contract principles on which nearly all non-signatories rely – (1) equitable estoppel, and (2) third party beneficiary.

### **1. Equitable Estoppel**

In order for equitable estoppel to permit a non-signatory to compel arbitration against a signatory, the non-signatory must establish that: (1) a close relationship exists between the entities involved, and (2) the claims against it are intimately founded in and intertwined with the underlying contractual obligations.<sup>150</sup> Claims are intertwined with an arbitration agreement when the signatory’s claims “rely on the terms of the agreement or assume the existence of, arise out of, or relate directly to, the written agreement.”<sup>151</sup>

Equitable estoppel cases involve situations where the claims the signatory brings are intertwined with the franchise agreement and yet the signatory attempts to avoid the arbitration

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<sup>145</sup> See, e.g., *First Options of Chicago, Inc. v. Kaplan*, 514 U.S. 938, 944 (1995) (arbitration may resolve disputes “that the parties have agreed to submit to arbitration”).

<sup>146</sup> 556 U.S. 624 (2009)

<sup>147</sup> *Id.* at 627.

<sup>148</sup> *Id.* at 631.

<sup>149</sup> *Flintkote Co. v. Aviva PLC*, 769 F.3d 215, 220 (3d Cir. 2014).

<sup>150</sup> *Torres v. CleanNet, U.S.A., Inc.*, 90 F. Supp. 3d 369, 379 (E.D. Pa. 2015) (citing *Griswold v. Coventry First LLC*, 762 F.3d 264, 271 (3d Cir. 2014)); see also *Sanchez v. CleanNet U.S.A., Inc.*, 78 F. Supp. 3d 747, 758 (N.D. Ill. 2015).

<sup>151</sup> *Torres*, 90 F. Supp. 3d at 379.

provision by bringing the claims against non-signatories. These cases will often involve a franchisee bringing a contract or tort claim derivative of the franchise agreement (e.g., fraud) against corporate officers or parents/subsidiaries of the franchisor. Often in those instances, the courts will permit the non-signatory to compel arbitration.

For example, in an action involving the CleanNet system, a franchisee brought a class claim regarding its misclassification as an independent contractor instead of an employee. The franchisee sued not only the corporate franchisor, but also the area development entities, which did not sign the franchise agreement.<sup>152</sup> The court determined the non-signatories could compel arbitration via the franchise agreement's arbitration clause because the franchisee's claims regarding independent contractor/employee status stem from the franchise agreement. Therefore, the signatory-franchisee was estopped from avoiding the arbitration clause he agreed to in the franchise agreement.<sup>153</sup>

In another case involving the CleanNet franchise system, a franchisee sued the franchisor and non-signatory area development company alleging improper classification and fraud in the inducement of the franchise agreement.<sup>154</sup> The trial court held that equitable estoppel prohibited the franchisee from avoiding arbitration with the non-signatory area development entity because the franchisee's complaint alleged that the franchisor and area development entity were a single entity.<sup>155</sup>

Also, in a case involving the bankrupt CD Warehouse franchisor, a franchisee sued the principals of the franchisor for fraud.<sup>156</sup> The non-signatory principals sought to compel arbitration under the franchise agreement and the Eighth Circuit obliged, holding that the claims against the principals for fraud were intertwined with the franchise agreement.<sup>157</sup>

There are cases where the non-signatory cannot compel arbitration. In a case involving retailers and wholesalers in the grocery business, multiple retailers sued multiple wholesalers in federal court alleging federal anti-trust violations.<sup>158</sup> Notably, each retailer had an agreement with the wholesaler which contained an arbitration clause. However, when bringing the claims, the retailers avoided bringing claims against its "direct" wholesaler, instead suing another wholesaler with whom it did not have a direct contractual relationship.<sup>159</sup> The wholesalers moved to dismiss the retailers' claims and compel arbitration, arguing equitable estoppel and successor in interest.

In discussing the "intertwined" requirement of the estoppel test, the court *In re Wholesale Grocery* held that alleging a conspiracy between signatory and non-signatory defendants is not sufficient to establish that the claim is intertwined with the contract, especially when the anti-

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<sup>152</sup> *Id.* at 378.

<sup>153</sup> *Id.* at 380.

<sup>154</sup> *Sanchez*, 78 F. Supp. 3d at 751.

<sup>155</sup> *Id.* at 758.

<sup>156</sup> *CD Partners, LLC v. Grizzle*, 424 F.3d 795, 797-98 (8th Cir. 2005).

<sup>157</sup> *Id.* at 799.

<sup>158</sup> *In re Wholesale Grocery Prods. Antitrust Litigation*, 707 F.3d 917, 919-21 (8th Cir. 2013).

<sup>159</sup> *Id.* at 920.

trust claim at issue derives from a statute.<sup>160</sup> Therefore, the court refused the non-signatory's attempt to compel arbitration.<sup>161</sup>

## **2. Third-Party Beneficiary**

In some states, third-party beneficiaries may enforce the terms of a contract where it clearly expresses an intent to benefit the party or an identifiable class of which the party is a member.<sup>162</sup> In *Torres v. Simpatico, Inc.*, a class of plaintiffs brought a RICO action against the Stratus Franchising system (a commercial cleaning business) and various individuals related to the franchisor. The arbitration provision in the franchise agreement provided in pertinent part that "the provisions of [the arbitration agreement] are intended to benefit and bind certain third party non-signatories..."<sup>163</sup> Applying Missouri law which permits third party beneficiaries to enforce the terms of a contract, the court held that the non-signatories could enforce the arbitration clause, based on the express language in the agreement.<sup>164</sup>

The effectiveness of a third-party beneficiary theory will be a state-by-state determination. States vary on whether and to what extent third parties may enforce the terms of a contract. Therefore, when drafting or agreeing to an arbitration provision, a review of the applicable state law regarding third-party beneficiaries is advisable.

### **C. When a Signatory Seeks to Compel Arbitration Against Non-Signatory**

Generally, an agent of a disclosed principal, even one who negotiates and signs a contract for her principal, does not become a party to the contract.<sup>165</sup> Moreover, under traditional agency principles, the only other way an agent will be bound by the terms of a contract is if he/she is made a party to the contract by the principal with actual, implied, or apparent authority.

If there is no actual, implied or apparent authority, it comes down to an analysis of the contractual factors set forth in *Arthur Anderson* and a number of other Circuit decisions: assumption, piercing the corporate veil, alter ego, incorporation by reference, third-party beneficiary theories, waiver and estoppel.<sup>166</sup> In order for a signatory to compel arbitration against a non-signatory, the signatory must establish one of these contractual factors.<sup>167</sup>

In a case involving the Dunkin' Donuts system, the court refused to enforce a contractual jury trial waiver against a corporate franchisee plaintiff (only the individuals signed the franchise agreement). The court made reference to the general refusal to enforce arbitration provisions

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<sup>160</sup> *Id.* at 923.

<sup>161</sup> *Id.* at 924.

<sup>162</sup> *Torres v. Simpatico, Inc.*, 995 F. Supp. 2d 1057, 1064 (E.D. Mo. 2014), *aff'd*, 781 F.3d 963 (8th Cir. 2015).

<sup>163</sup> *Id.* at 1062.

<sup>164</sup> *Id.* at 1065.

<sup>165</sup> See, e.g., *Bel-Ray Co., Inc. v. Chemrite (Pty) Ltd.*, 181 F.3d 435, 445 (3d Cir. 1999).

<sup>166</sup> *Arthur Anderson*, 556 U.S. at 627; see also *Thomson-CSF, S.A. v. Am. Arbitration Ass'n*, 64 F.3d 773, 776 (2d Cir.1995).

<sup>167</sup> *Torres*, 995 F. Supp. 2d at 1065 (finding that a non-signatory master franchisor was an intended third-party beneficiary of arbitration provision).

against non-signatories as a basis for the ruling.<sup>168</sup> In fact, the court advised that even if there was proof of agency between the individual and corporate franchisees, it would not enforce the jury trial waiver against the corporate franchisee because in the Third Circuit a contractual arbitration provision is unenforceable against a non-signatory agent.<sup>169</sup>

## V. ENFORCING AND AVOIDING VENUE CLAUSES

Businesses that operate outside of their home states, including franchisors, often rely on a venue clause to control the situs of any arbitration/litigation and thus limit certain risk, including lower litigation costs and avoiding antagonistic out-of-town judges/juries. Although the home-field advantage in professional sports is accepted, there are no definitive statistics on home-field advantage in lawsuits resolved on the merits. However, there is no doubt that franchisors are advantaged by home-state forum selection clauses, as it is nearly undisputed that out-of-state litigation is much more burdensome, including time away from the franchise, and more costly on the franchisee as opposed to the franchisor. This often leads to submission by the franchisee.

To protect franchisees, a number of states have adopted franchise statutes that invalidate provisions requiring venue outside of that state. For instance, the California Franchise Relations Act states that a “provision in a franchise agreement restricting venue to a forum outside this state is void with respect to any claim arising under or relating to a franchise agreement involving a franchise business operating within this state.”<sup>170</sup>

However, the Supreme Court and a majority of federal and state courts provide that Section 2 of the FAA preempts those state venue laws.<sup>171</sup> That is not to say that these state laws do not have an effect, as state regulators have used these statutes to force state-specific addenda to franchise agreements.<sup>172</sup> Whether to avoid or to enforce a venue provision in a franchise agreement is a case-by-case undertaking.

### A. The Atlantic Marine Decision – Federal Court Venue

In *Atlantic Marine Construction Co. v. U.S. District Court for the Western District of Texas*, the Supreme Court addressed the confluence of Federal court venue standards and venue provisions in contracts.<sup>173</sup> The Supreme Court held that Congress intended that “venue should always lie in *some* federal court whenever federal courts have personal jurisdiction over

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<sup>168</sup> *Selzer v. Dunkin’ Donuts, Inc.*, No. 09-5484, 2014 WL 1340549, at \*3 (E.D. Pa. April 4, 2014).

<sup>169</sup> *Id.* (citing *Bel-Ray*, 181 F.3d at 445).

<sup>170</sup> Cal. Bus. & Prof. Code § 20040.5.

<sup>171</sup> See Sawan Patel and Susan Tegt, *State Regulators Circumvent Venue Clauses for Arbitration*, 18 THE FRANCHISE LAWYER 1 (Winter 2015), citing e.g., *Southland Corp. v. Keating*, 465 U.S. 1; *Bradley v. Harris Research*, 275 F.3d 884 (9th Cir. 2001) (FAA preempted out-of-state venue restriction in California Franchise Investment Law); *KKW Enters. v. Gloria Jean’s Gourmet Coffees Franchising Corp.*, 184 F.3d 42 (1st Cir. 1999) (FAA preempted out-of-state venue restriction in Rhode Island Franchise Investment Act); *Doctor’s Assoc. v. Hamilton*, 150 F.3d 157 (2d Cir. 1998) (FAA preempted out-of-state venue provision in New Jersey Franchise Practices Act); *Mgmt. Recruiters Int’l, Inc. v. Bloor*, 129 F.3d 851, 856 (6th Cir. 1997) (validity of Washington Franchise Investment Protection Act “would be in serious doubt as a result of the preemptive effect of the FAA” if it “imposed an absolute requirement of in-state arbitration); *Alphagraphics Franchising v. Whaler Graphics*, 840 F. Supp. 708 (D. Ariz. 1993) (FAA preempted out-of-state venue restriction in Michigan Franchise Investment Law).

<sup>172</sup> Sawan, *supra* note 171.

<sup>173</sup> 571 U.S. 49 (2013).

the defendant.<sup>174</sup> The Court further held that venue is *proper* so long as the requirements of § 1391(b)<sup>175</sup> are met, irrespective of any [venue/forum] selection clause in a contract.<sup>176</sup>

However, even though a particular venue is proper under § 1391(b), that does not mean that a contractual venue provision that differs from the chosen venue cannot be enforced in federal court. Section 1404(a) provides that “[f]or the convenience of parties and witnesses, in the interest of justice, a district court may transfer any civil action to any other district or division where it might have been brought **or to any district or division to which all parties have consented.**”<sup>177</sup>

In analyzing a transfer of venue under Section 1404(a), the Supreme Court held that a venue/forum selection clause will be “given controlling weight in all but the most exceptional cases... [because] the enforcement of valid forum selection clauses, bargained for by the parties, protects their legitimate expectations and furthers vital interests of the justice system.”<sup>178</sup> Thus, to avoid a valid venue provision in a franchise agreement in federal court the options are limited.

## **B. Contravening State Venue Statutes**

A party might attempt to avoid a contractual venue clause by asserting that a state franchise statute prohibits venue in another state, *e.g.*, California’s Franchise Relations Act (“CFRA”).<sup>179</sup> Most federal courts that have considered this argument have ruled that the CFRA does not trump the party’s valid contractual venue clause.<sup>180</sup> However, courts in Colorado and Pennsylvania have applied the CFRA in voiding a contractual venue/forum clause on public policy grounds.<sup>181</sup>

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<sup>174</sup> *Atlantic Marine*, 571 U.S. at 56 (emphasis in original). In some contexts the word “venue” is used synonymously with the term “forum,” but 28 U.S.C. §1391 makes clear that venue in “all civil actions” must be determined in accordance with the criteria outlined in that section. *Id.*

<sup>175</sup> Section 1391(b) provides: “Venue in general.--A civil action may be brought in - (1) a judicial district in which any defendant resides, if all defendants are residents of the State in which the district is located; (2) a judicial district in which a substantial part of the events or omissions giving rise to the claim occurred, or a substantial part of property that is the subject of the action is situated; or (3) if there is no district in which an action may otherwise be brought as provided in this section, any judicial district in which any defendant is subject to the court’s personal jurisdiction with respect to such action.”

<sup>176</sup> *Atlantic Marine*, 571 U.S. at 57.

<sup>177</sup> 28 U.S.C. § 1404(a) (emphasis added).

<sup>178</sup> *Atlantic Marine*, 571 U.S. at 60, 63.

<sup>179</sup> Cal. Bus. & Prof. Code § 20040.5.

<sup>180</sup> *Maaco Franchising, Inc. v. Tainter*, No. 12-cv-5500, 2013 WL 2475566, at \* 4 (E.D. Pa., June 10, 2013) (citing *TGI Friday’s Inc. v. Great Nw. Rests., Inc.*, 652 F. Supp. 2d 750, 760 & n. 9 (N.D. Tex. 2009) (The only argument defendants make concerning the enforceability of the venue clause is that it is void under California law. Defendants do not explain in any detail why this court should apply California law to void a franchise agreement that provides that Texas law applies to all matters relating to the agreement, and that Texas is the venue for any disputes relating to the agreement.); *Hoodz Int’l, LLC v. Toschiaddi*, No. 11–15106, 2012 WL 883912, at \*4 (E.D. Mich. Mar. 14, 2012) (“As an initial matter, Defendants fail to articulate why the venue question implicates [§ 20040.5], or any other California law, in the context of this dispute. The relevant contracts expressly state that they should be interpreted under Michigan law.”).

<sup>181</sup> See *Homewatch Int’l, Inc. v. Pac. Home Care Servs., Inc.*, No. 10–3045, 2011 WL 1660612, at \*3 (D. Colo. May 2, 2011) (applying California law to a franchise agreement expressly governed by Colorado law and finding the venue/forum clause void and unenforceable as contrary to strong and express California public policy, but noting that

### C. Waiver of Venue Clause

The waiver of venue clauses requires: “(1) an existing right, benefit, or advantage; (2) actual or constructive knowledge of its existence; and (3) actual intent to relinquish that right.”<sup>182</sup> Waiver can also occur if a party engages in “conduct so inconsistent with the intent to enforce the right as to induce a reasonable belief that it has been relinquished, such as substantially invokes the judicial process [in derogation of the venue clause] and thereby causes detriment or prejudice to the other party.”<sup>183</sup> For instance, an automobile franchisee sought affirmative relief (summary judgment) from the court and therefore waived any objection to venue.<sup>184</sup> Moreover, the Fifth Circuit has held that a party does not waive its right to invoke a forum selection clause in a contract by filing suit on a related guaranty that does not contain any such clause.<sup>185</sup>

### D. Rescission by Franchisee Does not Invalidate Venue Clause

In a matter involving a specialty gym for special needs children in New Jersey, the franchisee argued that the venue clause in the franchise agreement was unenforceable by the franchisor because the franchisee’s lawyer had previously sent a letter rescinding the franchise agreement.<sup>186</sup> More specifically, the franchisee alleged that the franchisor breached the agreement and sued in New Jersey arguing that the California venue clause in the agreement was invalid because the franchisee had rescinded the agreement prior to filing its lawsuit. The Court was unconvinced by franchisee’s argument, since it had no legal authority to support it and cases had found that rescission does not invalidate a venue clause.<sup>187</sup>

A plaintiff cannot “credibly argue” that a franchise agreement is no longer operative, yet predicate its claims on that very agreement.<sup>188</sup> If the rescission is based on a breach of the franchise agreement or fraud related thereto, the plaintiff cannot avoid the contract’s venue

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this finding does not by itself mandate transfer to a California court); *cf. Cottman Transmission Sys., LLC v. Kershner*, 492 F. Supp. 2d 461, 467–71 (E.D. Pa. 2007) (holding that application of a Pennsylvania choice-of-law provision was contrary to the California policy where California had a “materially greater interest” than Pennsylvania in the underlying issues, and standards and remedies available under California franchise statutes provided substantially greater “quality of protection” to franchisees).

<sup>182</sup> *SGIC Strategic Global Investment Capital, Inc. v. Burger King Europe GMBH*, 839 F.3d 422, 426 (5th Cir. 2015).

<sup>183</sup> *Id.* (quoting *Al Rushaid v. Nat’l Oilwell Varco, Inc.*, 757 F.3d 416, 421 (5th Cir. 2014)).

<sup>184</sup> *FCA US, LLC v. Spitzer Autoworld Akron, LLC*, No. 16-11186, 2017 WL 512790, at \*10 (E.D. Mich. Feb. 8, 2017) (citing *State Auto Ins. Co. v. Thomas Landscaping & Const., Inc.*, 494 F. App’x. 550 (6th Cir. 2012)).

<sup>185</sup> *SGIC*, 839 F.3d at 427 (“By asserting its rights under a distinct agreement that did not contain a forum selection clause, Defendant cannot be held to have intended to waive a right under the franchise agreements.”).

<sup>186</sup> *Bella & Rosie Rock, LLC v. We Rock the Spectrum, LLC*, No. 17-3628, 2018 WL 844398, at \*1 (D.N.J. Feb. 13, 2018).

<sup>187</sup> *See, e.g., Wholesale Merch. Processing, Inc. v. Orion Commc’ns, Inc.*, No. 03:12–CV–02003, 2013 WL 1361863, at \*4 (D. Or. Mar. 4, 2013) (rejected this argument, reasoning: “[Plaintiff] further argues [defendant’s] alleged breach of the Agreement allows [plaintiff] to rescind the Agreement in its entirety, including the venue clause. The court agrees with [defendant] that this argument puts the proverbial cart before the horse. Whether [plaintiff] can rightfully rescind the Agreement is one of the questions that must be decided in this case. Interpretation of the venue clause is necessary to determine where the rescission claim will be tried); *Starlight Co. v. Arlington Plastics Mach., Inc.*, No. C011121SI, 2001 WL 677908, at \*4 (N.D. Cal. June 8, 2001) (rejecting plaintiff’s argument that allegations of rescission rendered venue clause unenforceable, stating “plaintiff presents no cases where a court has rescinded an entire contract for the purposes of invalidating a forum-selection clause” and “[g]ranteeing a rescission of the Contract to invalidate the forum-selection clause would essentially give plaintiff the relief it seeks without requiring it to prove its case.”).

<sup>188</sup> *Bella & Rosie Rock*, 2018 WL 844398, at \*4.

provisions. Thus, granting rescission of an agreement to avoid the venue clause “would effectively give plaintiff the relief it seeks without requiring it to prove its case.”<sup>189</sup>

## VI. WAIVER OF RIGHT TO ARBITRATE

An issue that occasionally arises in litigation involving franchise agreements is whether a party has waived its right to arbitrate. The common fact pattern is when a franchisee files its claim in a trial court and the franchisor answers the complaint and engages in discovery. Then, after the franchisor engages in discovery, it seeks to compel arbitration.

The question of whether a party has waived its right to arbitration is inherently fact-specific and courts are generally reluctant to find a waiver. This reluctance derives from the strong presumption in favor of arbitration and against waiver found in the FAA.<sup>190</sup> With that said, there are times when waiver of the right to arbitrate has been found and there are some general guidelines to determine where the non-waiver/waiver threshold is located.

Section 2 of the FAA provides that “a contract ... to settle by arbitration a controversy ... shall be valid, irrevocable and enforceable, save upon such grounds as exist at law or in equity for the revocation of any contract.”<sup>191</sup> Waiver is one of those grounds.

### A. General Principals in Examining Waiver

In most jurisdictions, a “heavy burden of proof” is placed on the party arguing for waiver of the right to arbitration and the courts often resolve all doubts in favor of arbitration.<sup>192</sup> Waiver will only occur if the party requesting arbitration “has substantially invoked the judicial process to its opponent’s detriment.”<sup>193</sup> Moreover, the waiver of the right to arbitrate must be intentional.<sup>194</sup>

There is a conflict regarding whether the party asserting that the right to arbitration was waived must also prove that it suffered prejudice. The majority view is that absent a showing of prejudice by the opposing party, “waiver does not result by invoking the judicial process alone.”<sup>195</sup> In examining prejudice, courts “consider the length of delay in demanding arbitration and the expense incurred by the party from participating in the litigation process.”<sup>196</sup> However, although a minority of courts have held that the party asserting waiver is not required to prove that it suffered any prejudice, it is still a factor in the analysis.<sup>197</sup>

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<sup>189</sup> *Starlight Co.*, 2001 WL 677908, at \*4.

<sup>190</sup> *In re Bath Junkie Franchise, Inc.*, 246 S.W.3d 356, 367 (Ct. App. Tex. 2008).

<sup>191</sup> 9 U.S.C. §2.

<sup>192</sup> *In re Bath*, 246 S.W.3d at 367; see also *Geo Vantage of Ohio, LLC v. GeoVantage, Inc.*, No. 05-1145, 2006 WL 2583379, at \*9 (S.D. Ohio, Sept. 6, 2006).

<sup>193</sup> *In re Bath*, 246 S.W.3d at 367; see also *Beaver v. Inkmart, LLC*, No. 12-60028, 2012 WL 3834944, at \*3 (S.D. Flor., Sept. 4, 2012); *Doctor’s Assocs., Inc. v. Melton*, No. 01-1842, 2001 WL 34150394, at \*3 (D. Conn., Nov. 30, 2001).

<sup>194</sup> *Geo Vantage*, 2006 WL 2583379, at \*9.

<sup>195</sup> *In re Bath*, at 367; see also *Lawrence v. Comprehensive Business Services Co.*, 833 F.2d 1159, 1164-65 (5th Cir. 1987).

<sup>196</sup> *Beaver*, 2012 WL 3834944, at \*4 (citing *Krinsk v. SunTrust Banks, Inc.*, 654 F.3d 1194, 1201 (11th Cir. 2011)).

<sup>197</sup> *Hill v. Ricoh Ams. Corp.*, 603 F.3d 766, 774-75 (10th Cir. 2010) (not a franchise case).

The majority of courts use a two or three part test which incorporates some of the principals set forth above, and include prejudice as a requirement.<sup>198</sup> Specifically, for the three part test courts consider (1) the length of time between commencement of litigation and the request for arbitration; (2) the degree to which litigation of the claim has been pursued through motion practice and discovery; and (3) proof of prejudice to the party opposing arbitration.<sup>199</sup> Notably, under this test a lengthy delay, coupled with engaging in significant discovery, will not waive the right to arbitration unless prejudice is proven.

### **1. Passage of Time**

Surprisingly, the amount of time that passes before asserting a right to arbitration is not as dispositive as one might believe. There are a number of examples where the passage of time between the filing of the complaint and the assertion of a right to arbitration was lengthy, but was not found to support a waiver – for example, 5 months<sup>200</sup> and 14 months<sup>201</sup>.

### **2. Filing of Answer/Counterclaim**

A defendant filing an answer or counterclaim does not automatically waive its right to compel arbitration of those claims.<sup>202</sup> Similarly, the failure to timely pursue arbitration after asserting the right to arbitrate as an affirmative defense in answering a complaint is not a waiver.<sup>203</sup>

### **3. Engaging in Discovery**

The amount of discovery undertaken is also not dispositive of whether a waiver has occurred. For instance, a party engaging in “extensive discovery” was found not to have waived the right to arbitrate,<sup>204</sup> even if that discovery includes depositions.<sup>205</sup> That is not to conclude, however, that there is no limit to the amount of discovery that can occur without risking waiver, as it has been held that a plaintiff engaging in document requests, requests for admissions and depositions, had waived the right to arbitration.<sup>206</sup>

### **4. When Waiver Is Found**

In general, a waiver of the right to arbitrate has been found “when the party charged with waiver [was] delaying until the very last opportunity or even until it has lost on the merits.”<sup>207</sup>

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<sup>198</sup> James Savage, *The Majority Approach to Arbitration Waiver: A Workable Test or A License for Litigants to Play Games with the Court?*, UNIVERSITY OF NEW HAMPSHIRE LAW REVIEW, Vol. 11, No. 2, Article 6, at n.79.

<sup>199</sup> *Melton*, 2001 WL 34150394, at \*3; see also *Doctor's Associates, Inc. v. Distajo*, 944 F. Supp. 2d 1010, 1014 (D. Conn. 1996); *Beaver*, 2012 WL 3834944, at \*3 (using a two part test which combines the first two parts of three part test).

<sup>200</sup> *Melton*, 2001 WL 34150394, at \*4.

<sup>201</sup> *In re Bath*, 246 S.W.3d at 368.

<sup>202</sup> *Id.*

<sup>203</sup> *Sentry Sys., Inc. v. Guy*, 654 P.2d 1008, 1009 (Nev. 1982).

<sup>204</sup> *Rush v. Oppenheimer & Co.*, 779 F.2d 885, 887 (2d Cir. 1985).

<sup>205</sup> *In re Bath*, 246 S.W.3d at 368.

<sup>206</sup> *Beaver*, 2012 WL 3834944, at \*3.

<sup>207</sup> *Melton*, 2001 WL 34150394, at \*4.

Waiver appears to be the exception, not the rule, but there are egregious scenarios that support waiver.<sup>208</sup> For instance, waiver was found where the right to arbitration was invoked (1) on the eve of trial after a fifteen-month delay and taking 3 depositions and producing 2,100 pages of documents,<sup>209</sup> (2) after losing on the merits,<sup>210</sup> and (3) after a plaintiff filed a complaint, amended complaint, sought a default judgment and engaged in discovery.<sup>211</sup>

## **5. Waiver – Affiliated Entities**

There is a relatively recent case regarding waiver of arbitration with respect to affiliated entities.<sup>212</sup> Specifically, the court found that counter-defendant Money Mailer Franchise Corporation (MMF) waived its right to arbitrate with a former franchisee (Brewer) based on the litigation conduct of an MMF affiliate that the franchisees were required to use. More specifically, MMF's franchisees were required to contract directly with MMF's affiliated entity, MMLLC, for certain services and materials essential to the franchise. MMLLC sued the franchisee for failing to pay for the services and materials. The franchisor was dragged into the litigation and sought to enforce the franchise agreement's arbitration clause. The court refused to compel arbitration, because the amounts that MMLLC sought to recover were intertwined with amounts owed to the franchisor. Therefore, the court found that MMLLC's lawsuit to recover amounts that were intertwined with amounts owed to MMF was inconsistent with MMF's right to arbitrate, and thus the franchisor's affiliated entity had in effect waived the franchisor's right to arbitrate.

### **B. Conclusions**

In reviewing the totality of the cases on the subject, it appears that the closer the parties are to having the court decide the case on the merits – whether via summary judgment or trial (regardless of how much time has passed on the calendar) – the greater the chance there will be a finding of prejudice and a finding of waiver.

## **VII. DRAFTING ARBITRATION CLAUSES TO MITIGATE ENFORCEMENT RISK**

As this paper demonstrates, the precise wording of the arbitration clause is the determining factor in whether the clause will be enforced. The focus on the language of the clause makes sense as arbitration is first and foremost a voluntary procedure; a creature of contract. Although we have seen in the sections above that the case law and statutory regimes strongly favor arbitration, even those laws cannot overcome a poorly drafted arbitration clause. Accordingly, this final section of the paper provides a framework for how to draft an effective and enforceable arbitration provision.

### **A. Guidelines for the Arbitration Clause Drafter**

Arbitration clauses come in all shapes and sizes. There is no one perfect clause. But, there are guidelines for both the wording and content of the clause that a drafter can follow to ensure that an arbitration clause will be suitable for your client's needs. It is beyond the scope

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<sup>208</sup> *Melton*, 2001 WL 34150394, at \*4.

<sup>209</sup> *Kingston v. Latona Trucking, Inc.*, 159 F.3d 80, 83-84 (2d Cir. 1998).

<sup>210</sup> *Cotton v. Slone*, 4 F.3d 176, 179-80 (2d Cir. 1993).

<sup>211</sup> *Beaver*, 2012 WL 3834944, at \*4.

<sup>212</sup> *Money Mailer, LLC v. Brewer*, No. C15-1215RSL, 2017 WL 3017539 (W.D. Wash. July 7, 2017).

of this paper to address all possible issues related to an arbitration clause. This Section will instead begin with a focus on those elements that provide the essential framework for drafting an enforceable arbitration provision, before addressing how to add elements to defend against the enforcement challenges described above.

## **1. Preliminary Tips**

The precise wording of your arbitration clause starts with good general contract drafting skills and then expands into the finer points of scope and substance. Before getting into that scope and substance, however, we offer a few pieces of practical advice that a drafter should consider when preparing an arbitration clause.

### **a. Use a Litigator in the Drafting Process!**

Perhaps the best drafting resource available is the one that far too often goes unused - a litigator. Litigators have a wealth of knowledge when it comes to drafting contract clauses. Whether available to you within your firm or through colleagues in the ABA, transactional drafters are strongly encouraged to "pressure test" the wording of their arbitration clauses with a trusted litigator before the clause is finalized. The last thing that clients want to litigate is the issue of where to litigate. An experienced litigator can opine as to whether the clause will be enforced as drafted, and provide a second set of eyes to ensure the client's goals for other aspects of the clause are met. Among other things, a litigator can provide insight into the arbitration tribunal selected, the procedural rules, and other aspects of the litigation. Using a litigator in the drafting process can provide a proactive strategic advantage, and help avoid the time, expense, and frustration that could arise later if there are holes in the clause.

### **b. Tools and Checklists**

Every good contract drafter has a mechanism for staying on top of current issues and collecting contract language that has been battle tested. For lawyers just starting out or needing to supplement their resources, this can sometimes seem to be a daunting task. But, worry not; there are numerous resources readily available to assist in the drafting process. General language, checklists, and technologies are available from multiple sources, including professional organizations and even the arbitration tribunals themselves.

For instance, the AAA recently launched a free computerized program called "ClauseBuilder".<sup>213</sup> That computer program can assist the drafter with building a clause, simply by clicking boxes in responses to questions posed regarding the intended scope of the arbitration clause. Similarly, JAMS has the "JAMS Clause Workbook", which provides advice on the scope of the clause and suggests model language for the drafter to incorporate or customize.<sup>214</sup>

Although resources from an arbitration tribunal will be clearly slanted toward using their services (including their fee structures, procedural rules, and perhaps other add-on services, such as mandatory mediation), they do provide a solid starting point for preparing an enforceable clause and keeping one apprised of developments in the case law. Using these resources as a baseline, the drafter can then enhance and customize the clause using the case

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<sup>213</sup> <https://www.clausebuilder.org>

<sup>214</sup> <https://www.jamsadr.com/clauses>

law and resources from organizations like the ABA Forum on Franchising.<sup>215</sup> These resources can keep a drafter on the cutting edge of issues and make the difference between clauses that are enforced and those that result in unwanted and unnecessary litigation later.

## 2. Elements of the Clause

Parties are free to structure an arbitration clause to address virtually all aspects of how a dispute will be resolved. Before looking at some advanced drafting issues, this Section highlights and emphasizes the foundational elements that every arbitration clause should contain. These elements include language ensuring that the dispute will in fact be resolved in arbitration, selecting the administrator, establishing the rules and procedures for arbitration, and addressing the type and enforceability of the award itself.

### a. Scope of Clause

Perhaps the most fundamental issue in drafting an arbitration clause is to define what disputes are actually subject to arbitration. This may seem basic, but, as seen above, it is all too often the source of enforcement disputes.

Take, for example, a clause that requires arbitration of "[a]ny controversy, claim or dispute arising from the franchise agreement". At first glance, this clause may seem to be relatively broad in scope and sufficient to send a dispute to arbitration. But, when examined more closely, it arguably applies only to contract claims. In the franchise context, this could mean that your clause does not extend to the numerous other disputes that could arise in the franchise relationship, including common law tort claims, statutory claims, or claims arising from agreements other than the franchise agreement (supply agreements, guarantees, etc.).<sup>216</sup>

To mitigate against this risk, a better practice is to draft the clause broadly to ensure it covers (subject to any carve-outs) any litigation, disputes, claims, controversies, or actions arising from or related to the franchise relationship, not just the franchise agreement. An example of a broadly worded sample clause is as follows:

- EXCEPT FOR DISPUTES (AS DEFINED BELOW) RELATED TO OR BASED ON THE MARKS (WHICH AT OUR SOLE OPTION MAY BE SUBMITTED TO ANY COURT OF COMPETENT JURISDICTION) AND EXCEPT AS OTHERWISE EXPRESSLY PROVIDED BY THIS AGREEMENT, ANY LITIGATION, CLAIM, DISPUTE, SUIT, ACTION, CONTROVERSY, PROCEEDING OR OTHERWISE ("DISPUTE) BETWEEN OR INVOLVING YOU AND US (AND/OR INVOLVING YOU AND/OR ANY CLAIM AGAINST OR INVOLVING ANY OF OUR OR OUR AFFILIATES' SHAREHOLDERS, DIRECTORS, PARTNERS, OFFICERS, EMPLOYEES, AGENTS, ATTORNEYS, ACCOUNTANTS, AFFILIATES, GUARANTORS OR OTHERWISE), WHICH IS NOT RESOLVED WITHIN 45 DAYS OF NOTICE FROM EITHER YOU OR WE TO THE OTHER, MUST BE SUBMITTED TO ARBITRATION TO THE PLACE OF BUSINESS

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<sup>215</sup> See Julianne Lusthaus, Mary Leslie Smith & Quentin R. Wittrock, *Is Franchising Abandoning Arbitration? Current Trends in Arbitrating Franchise Disputes*, ABA 32nd ANNUAL FORUM ON FRANCHISING (2009) W-17; see also Ronald T. Coleman, Jr. & Justin M. Klein, *Drafting Dispute Resolution Clauses from a Litigator's Perspective*, ABA 37th ANNUAL FORUM ON FRANCHISING (2014) W-11; Joel D. Rosen & James B. Shrimp, *Yes to Arbitration, but Did I Also Agree to Class Action and Consolidated Arbitration*, 30 Franchise L.J. 175 (Winter 2011); Sawan S. Patel & Susan E. Tegt, *State Regulators Circumvent Venue Clauses for Arbitration*, 18 The Franchise Law. 5 (Winter 2015).

<sup>216</sup> See *Armijo v. Prudential Ins. Co.*, 72 F.3d 793, 800 (10th Cir. 1995).

OF THE AMERICAN ARBITRATION ASSOCIATION CLOSEST TO OUR HEADQUARTERS AT THE TIME OF THE DISPUTE.

By keeping the clause broad and inclusive, you best mitigate against the risk of challenges that some claims are not subject to arbitration. As seen above, the FAA will not act to save and expand clauses that are insufficiently drafted. While it is true that the courts will apply a liberal interpretation to the clause and resolve close calls in favor of arbitration, they will not interpret the clause beyond the plain language to encompass all disputes. If the clause is not drafted broadly enough, it is very possible that you will be fighting some issues in arbitration and others in a state or federal court. By adding the extra language to the clause to include the entire relationship, you ensure the broadest application possible and avoid such issues.

**b. Carve-Outs**

Along with thoroughly explaining the scope of what the clause is intended to cover, the parties should be careful to also address the issues that will not be subject to arbitration. Perhaps the most common "carve-out" is for matters of injunctive or emergency relief, such as those related to trademarks, unfair competition, or non-competes. Given the recent challenges to the enforcement of such carve-outs, parties must be careful to stay on top of the case law related to this evolving issue and proactively prepare the carve-out to address the same. As detailed in Section III above many of the successful challenges to carve-out provisions for emergency or injunctive relief have hinged, in one way or another, on (a) the fact that the rules of the arbitration administrator selected contain a procedure for emergency or injunctive relief; and (b) the failure of the clause to expressly and definitively address the delegation of emergency relief solely to a court rather than the arbitrator. Drafters will need to consider these current challenges and monitor future developments to prepare carve-outs that will be enforced and overcome the challenges detailed in Section III.

**c. Select the Administrator**

Once the scope and carve outs are decided, the drafter should next consider the administrative organization used to conduct the arbitration. This tip also may seem basic, but it too is often overlooked. Historically, drafters have blindly included either AAA or JAMS in their clauses. Often times they did so failing to truly understand the benefits or downsides of the administrative organization selected.<sup>217</sup> The various administrators have different procedural rules, costs, qualifications for its arbitrators, and timelines for getting through the proceedings. Drafters should instead investigate the administrative organizations to ensure that it meets the client's needs, and modify any rules and procedures that would adversely impact the manner in which they want the arbitration conducted.

**d. Select the Rules**

One of the primary benefits of arbitration is that the parties have control over the arbitration process and procedures. Among other things, the parties can choose to streamline discovery, timelines, and/or details of the hearing. Drafters should note, however, that it is not enough to generically state in the clause that the arbitration will be conducted by the administrative organizations' rules if you want to control any of the process (e.g. "the arbitration will be conducted by the American Arbitration Association Pursuant to its Commercial

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<sup>217</sup> See Julianne Lusthaus, Mary Leslie Smith & Quentin R. Wittrock, *Is Franchising Abandoning Arbitration? Current Trends in Arbitrating Franchise Disputes*, ABA 32nd ANNUAL FORUM ON FRANCHISING W-17, at 36 (2009).

Rules").<sup>218</sup> While each administration organization's rules are slightly different, they often fail to provide the structure the parties desire to streamline the arbitration process. Instead, these rules leave open issues to the discretion of the arbitrator. To ensure the process and rules desired, the parties should address at least the following four issues in the clause:

i. **How Will the Arbitrator be Selected?**

Arbitrator selection is a threshold issue that will have significant impact on the case. Absent a provision to the contrary, the arbitrator will be appointed from the administration organization's panel and pursuant to its rules. Those rules may result in someone deciding the case that is insufficiently qualified, or vest too much power within a single individual.

Parties instead should address issues related to the number and qualifications of the arbitrator(s) in the clause. Depending on the scope and complexity of the case, the parties may be fine with a single arbitrator or (generally for larger matters) may instead wish to have a panel of arbitrators. The parties may also be more comfortable with arbitrator(s) who have a minimum level of experience in franchising or with franchise disputes, or retired judges. Parties could also include non-lawyers with business experience in the franchise world (in the event of a multi-arbitrator panel). Whatever the parties' desires, if they wish to have some control over who decides their disputes, it is essential that these issues be included in the arbitration clause itself.

ii. **Discovery Rules**

Discovery has long been a controversial issue in arbitration. Arbitration historically streamlined discovery, making it a quicker and cheaper form of dispute resolution. But over the years, this benefit has largely disappeared making discovery in arbitration largely on par with discovery in state or federal court proceedings. Without a clause expressly limiting the scope of available discovery, the parties will be stuck with the selected administrative organization's rules, which often place these issues within the sole discretion of the arbitrator. To control the costs, timelines, and scope of discovery, drafters should instead prepare the clause to address material aspects of discovery, including the number of depositions, the type and scope of written discovery, timelines for discovery, and how to handle discovery disputes.

iii. **Dispositive Motions/Defaults**

Dispositive motions and defaults are powerful tools to pare down or even avoid lengthy legal dispute resolution processes. Until recently, however, these tools have been largely unavailable in arbitration proceedings. Several tribunals are evolving to allow for dispositive motions, but these motions are still relatively uncommon and unsuccessful. If the parties want to allow dispositive motions, they should expressly state so in the clause and specify the procedural rules by which these motions will be decided. The failure to do so will often result in defaulting to the rules of the arbitration administrator, which commonly place the use of dispositive motions within the discretion of the arbitrator.

iv. **Evidentiary Rules**

Another issue that can have a dramatic impact on the arbitration proceedings are what rules of evidence will apply. If the evidentiary rules are not addressed, the arbitrator has wide

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<sup>218</sup> See *In Wayland Lum Const., Inc. v. Kaneshige*, 90 Hawaii 417 (1999).

discretion to determine the admissibility and weight of evidence presented in the proceedings.<sup>219</sup> As anyone who has been involved in an arbitration is aware, the rules of evidence are sometimes so relaxed that there is very little way to control the scope of what evidence is admitted, thus leading to unwanted surprises and expanded hearings. By addressing the evidentiary rules in the clause, the parties can provide more structure and certainty to the hearing process.

#### e. The Award

The final essential element of building an arbitration clause is to address the type of award, as well as how and where it will be enforced. Taking first the issue of type of award, the parties can choose between a general award or one explaining the ruling (a "Reasoned Award").<sup>220</sup> A Reasoned Award can increase the cost of the proceeding, but it also has several benefits. For instance, far too often an arbitration award is overly general, leaving little or no way to know how the arbitrator reached her ruling, how she applied the evidence to the applicable legal standards, or even which claims were resolved in which party's favor. This can impact things like insurance coverage (e.g. if some claims were covered and others were not), fee shifting, and (although limited) any grounds to vacate or modify the award.<sup>221</sup> A Reasoned Award may assist with all of these issues, as well as forcing the arbitrator to issue the award in accordance with the applicable legal framework. If a Reasoned Award is desired, a drafter should be sure to specifically include the desire for such an award and the scope of the same in the arbitration clause itself. Generic references to a Reasoned Award may not be sufficient to force the arbitrator to put the award in the format desired by the parties.

After selecting the type of award decided, the parties must ensure that there is an agreed process and location for the enforcement of the award. It is not enough to simply go through arbitration and obtain an award. Instead, the FAA requires that the victorious party also confirm the award in a court of competent jurisdiction.<sup>222</sup> If a specific court or procedure is desired to confirm the award, the parties should address that in the arbitration clause. If the parties fail to do so, the confirmation process will default to the FAA, including Sections 9, 10 and 11.<sup>223</sup>

### 3. Customization of the Clause

With the foundational elements of the arbitration clause established, the parties are then free to further add to the clause to meet their needs. This may include significant issues such as selecting the substantive law, the forum and venue, limitation of remedies, confidentiality, or pre-arbitration mediation.

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<sup>219</sup> JAMS, JAMS COMPREHENSIVE ARBITRATION RULES & PROCEDURES r. 22(e) (2014); see <https://www.jamsadr.com/rules-comprehensive-arbitration>; AM. ARBITRATION ASS'N, COMMERCIAL ARBITRATION RULES r. 32 (2016); see <https://www.adr.org/Rules>.

<sup>220</sup> JAMS, JAMS COMPREHENSIVE ARBITRATION RULES & PROCEDURES r. 24 (2014); see <https://www.jamsadr.com/rules-comprehensive-arbitration>; AM. ARBITRATION ASS'N, COMMERCIAL ARBITRATION RULES r. 46 (2016); see <https://www.adr.org/Rules>.

<sup>221</sup> See 9 U.S.C. §§ 10, 11.

<sup>222</sup> See 9 U.S.C. §§ 9-11.

<sup>223</sup> *Id.*

Parties are also free to decide to prohibit class or collective actions. Generally, a franchisor will want to ensure that arbitration is conducted on an individual basis. If so, the franchisor should include express language in the arbitration clause stating that (a) all claims, controversies, disputes, or other actions be arbitrated on an individual basis; (b) neither party shall initiate any class, collective, or multi-party litigation against the other; and (c) neither party shall be a claimant or otherwise participate as a party in any class or collective, or multi-party claims or proceedings brought by any other person or entity.<sup>224</sup> If the clause is well-drafted, class action waivers are generally enforceable.<sup>225</sup>

Whatever the add-ons selected to customize the clause, drafters should be careful to consider prior case law and common enforcement challenges, like those addressed in this paper. Counsel should also constantly monitor the emerging attempts to nullify arbitration clauses, many of which arise outside of the franchise context. For example, franchisees have recently avoided arbitration by refusing to pay their portion of the fees.<sup>226</sup> To avoid this situation, drafters should add language to address what happens in the event of such non-payment. Another recent series of challenges relates to the alleged unconscionability or lack of mutuality of an arbitration clause. These challenges have been successful under certain state laws (such as California), and unsuccessful under the laws of other states.<sup>227</sup> The drafter needs to review potentially applicable laws and emerging issues to avoid successful challenges.

Again, there is no one perfect clause, but with the right focus and tools, drafters can create a clause suitable for their client's needs.

#### **4. A Note on International Arbitration**

Although a comprehensive discussion of international arbitration is beyond the scope of this paper, it should be noted that clauses which may be effective in U.S. agreements may not work in international agreements. That's not to say there are not common core elements; there are. International arbitration, like domestic arbitration, is contract based. Accordingly, the same drafting considerations that go into a domestic clause can be used to create an ideal international clause. The basic and advanced elements of the clause are largely the same, including the scope, selection of the administration institution, rules governing, location, applicable law, number and qualifications of arbitrators, and enforcement of the award. But within those issues the intricacies of applicable local laws, treaties, international arbitration administration organization rules and procedures, and even language barriers, can have a profound impact on the enforceability of the clause and the ultimate award. Drafters are advised to use the same process outlined above, but to pay special consideration to these issues when creating the international arbitration clause.

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<sup>224</sup> Ronald T. Coleman, Jr. & Justin M. Klein, *Drafting Dispute Resolution Clauses from a Litigator's Perspective*, ABA 37th ANNUAL FORUM ON FRANCHISING W-11, at 9 (2014).

<sup>225</sup> See *Stolt-Nielsen, S.A. v. Animal Feeds Int'l Corp.*, 559 U.S. 662, 130 S. Ct. 1758 (2010).

<sup>226</sup> See *Tillman v. Tillman*, 825 F.3d 1069 (9th Cir. 2016) (permitting a dispute to proceed in litigation after a party refused to pay its share of arbitration fees); See also *Pre-Paid Legal Services, Inc. v. Cahill*, 786 F.3d 1287 (10th Cir. 2015).

<sup>227</sup> *Nagrampa v. MailCoups, Inc.*, 469 F.3d 1257 (9th Cir. 2006) (finding an arbitration clause unconscionable under California law); see also *Barker v. Golf U.S.A., Inc.*, 154 F.3d 788 (8th Cir. 1998) (declining to find an arbitration clause unconscionable).

## BIOGRAPHIES

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