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Excerpts by Carmen D. Caruso from

Unconsionability and Franchise Litigation

Presented to the American Bar Association Forum on Franchising (2006)

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I. INTRODUCTION[1]

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

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

- Whether the franchisor had superior bargaining power and, if so, how much "superiority" is needed for the unconscionability doctrine to play a role.
- The level of the franchisee's business experience, and whether the franchisee was represented by counsel.
- Whether the franchisor was willing to negotiate any of the agreement's terms, or whether the franchisee even attempted to negotiate.
- Whether the challenged contract terms are widely used in franchising.

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

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

[3] DAVID G. EPSTEIN, ET AL., MAKING AND DOING DEALS: CONTRACTS IN CONTEXT 428 (2d ed. 2006).

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

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

- Whether the franchisee had a meaningful choice among different franchise investments with different contract terms.

- Whether the challenged contract terms have any business justification.

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

- In 2005, a California appellate court in *Independent Association of Mailbox Center Owners, Inc. v. Superior Court*[7] directed the trial court to enter an order striking as unconscionable the provisions in the franchise agreement barring representative or class arbitration, as well as clauses prohibiting arbitrators from granting relief otherwise authorized under a state statute.[8]

- In 2001, a California appellate court in *Bolter v. Superior Court*[9] characterized the franchise agreement between a "large wealthy international" franchisor and several "small" franchisees as a contract of adhesion (a contract that is presented on a take-it or leave-it basis)[10] and therefore held that the "place and manner" restrictions in the franchise agreement's arbitration clause requiring the franchisee to arbitrate in another state were unconscionable.

- Also in 2001, the United States Court of Appeals for the Ninth Circuit held in *Ticknor v. Choice Hotels International, Inc.*[11] that the arbitration clause in a pre-printed franchise agreement was unconscionable under Montana law "because it required binding arbitration of the weaker bargaining party's claims, but allowed the stronger bargaining party the opportunity to seek judicial remedies to enforce contractual obligations."[12]

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

It is also important to consider whether these recent unconscionability holdings will be extended (in California or elsewhere) beyond the realm of ADR, to invalidate other widely-used

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[6] *See* Alton L. Absher, III & Steven N. Baker, Empirical Study, *Unconscionability Never Really Works, Does It? An Empirical Study of How Courts Have Treated Unconscionability Under UCC Section 2-302*, (WAKE FOREST L. REV., Working Paper No. 4 2005), *available at* http://www.law.wfu.edu/prebuilt/Absher-Baker-ES.pdf. At least one law school professor teaches "his Contracts class to only use unconscionability as a last resort." *Id.* at n.2. *See also* Evelyn L. Brown, *The Uncertainly of U.C.C. Section 2-302: Why Unconsicionability Has Become a Relic*, 105 COM. L.J. 287, 306 (2000).

[7] 34 Cal. Rptr. 3d 659 (Cal. Ct. App. 2005).

[8] *Id.* at 676.

[9] 104 Cal. Rptr. 2d 888 (Cal. Ct. App. 2001).

[10] *See* Arthur A. Leff, *Unconscionability and the Code -- The Emperor's New Clause*, 115 U. PA. L. REV. 485, 504-06 (1967).

[11] 265 F.3d 931 (9th Cir. 2001) (applying Montana law).

[12] *Id*. at 940.

contract provisions that franchisees claim are unfair. If so, then we are standing on the threshold of a judicial revolution.

This paper addresses:

- The history and status of the unconscionability doctrine, why the doctrine was ignored for so long, and what, if anything, has changed;
- The recent unconscionability decisions invalidating ADR provisions, whether they were driven by their facts, and whether judicial attitudes toward unconscionability or arbitration have changed, at least in certain courts;
- Whether the recent unconscionability decisions are likely to be extended beyond ADR clauses, and beyond California and the Ninth Circuit; and
- Current strategies for litigating unconscionability claims given recent developments and how to anticipate the next wave of arguments.

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

II. SOME STATISTICS

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

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

Consumer cases involving the sale of goods are governed by the Uniform Commercial Code (the "Code" or "UCC"), Section 2-203 of which explicitly permits courts to refuse to enforce unconscionable contract terms. Even in those cases, however, the doctrine has not fared well. The Wake Forest Law Review has compiled an "empirical study" of all cases from 1965 through 2005 in which a party asserted unconscionability under Section 2-302 (the "Empirical Study"). According to this study, in the forty year period covered only 136 cases were decided strictly

[13] *See* Harold Brown, *Franchising: A Fiduciary Relationship*, 49 TEX. L.R. 650 (1971).

[14] Leff, *supra* note 10, at 532-33.

under Section 2-302.[15] Further, the rate at which litigants have even raised this claim under the Code has been in steady decline since the 1980's. Among the findings:

- In the 136 "Code cases" during the subject period, the overall success rate for unconscionability claims across the country was 28%, with most of the victories occurring in consumer/adhesion contract cases.[16]
    - However, both California and New York had higher than average success rates, 57% and 33% respectively.[17] Excluding California and New York, the national success rate declined to 22.6%.[18]
- Of the 136 Code cases, eighty-eight involved commercial parties on both sides of the contract, with one business entity contending that it entered into an unconscionable bargain with the other (as opposed to having an individual consumer make this claim).
    - In these eighty-eight cases, the success rate for unconscionability claims dropped to 12%.[19]
    - That 12% figure includes four cases in which the courts found that the parties had equal bargaining power (a finding that would not be expected in most franchise disputes). The success rate in those "equal bargaining power" cases dipped further to 4.5%.[20]
    - It can be presumed, therefore, that the success rate for cases between two commercial parties where there was *not* a finding of equal bargaining power would rise, but the present version of the Empirical Study does not provide sufficient data to make this precise calculation.[21]

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

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

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

[17] *Id.* at 14.

[18] *Id.*

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

[20] *Id.* at 18-20.

[21] The Empirical Study did not isolate the cases in which the courts made an express finding of unequal bargaining power.

[22] One of our summer associates reviewed a total of 484 cases, which were the combined results of searches for the terms "unconscion! w/s franchise," "franchise & found unconscionable'," and "franchise! w/s unconscionable not w/s not" in the Lexis database "Federal & State Cases, Combined." Unlike the Empirical Study, these search results were not limited to cases in which Section 2-302 provided the rule of decision. From the total of 484 search results, the courts in eleven cases made a finding of unconscionability. However, the converse is not true, as not each of the

III. BRIEF HISTORY OF THE DOCTRINE

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IV. UNCONSCIONABILITY IN FRANCHISING

A. The Fairness Debate

Calls for judicial intervention to protect franchisees by declaring franchise agreement terms unconscionable are not new. As early as 1967, the argument was made that clauses permitting termination without cause should be unenforceable.[23] That early call went nowhere.[24] In 1971, Harold Brown strenuously argued that numerous common franchise agreement provisions were the unconscionable result not only of franchisors' superior bargaining power, but also of their use of this power in the franchise sales process to impose very harsh terms upon unwary franchisees.[25] Among the terms that Brown denounced were:

> restrictions on transfer, covenants not to compete, and termination penalties; in particular compelling the franchisor who wants to repurchase a franchise to offer the franchisee the fair value of his business, with no compulsion on the franchisee to sell, and permitting the franchisee who wants to sell or make a gift of his franchise to do so to a person of his own choice who need be no more qualified than he was when he entered into the agreement.[26]

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

> The threat [to the franchisee's equity] is, of course, buttressed by the standard covenant not to compete, with one or more preemptive rights, all designed to assure that the franchisee will not terminate for fear of losing his investment and equity. The franchisor may even have an option to acquire the equipment at

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other 473 cases expressly rejected the unconscionability argument. Thus, we do not have an exact success rate from these search results.

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

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

[25] Brown, *supra* note 13, at 650.

[26] *Id*. at 671.

> depressed value. Additional control over the franchisee's equity is assured through arbitrary control over the right to transfer, a right of first refusal in case of sale, arbitration of all disputes at the franchisor's home office, and even compulsory resale under a one-sided formula. Moreover, since the franchisor always drafts the franchise agreement and adamantly declines to assent to any modification, he has an untrammeled opportunity to assure unfair self-preferences. Merely to illustrate, the right of first refusal is often aided by a prohibition on advertising the sale of the franchise until after the franchisor has refused the offer.[27]

We will not attempt to document every twist and turn in the "franchise fairness" debate from 1971 to the present, including efforts in litigation to impose upon franchisors a duty of competence[28] and/or fiduciary duties,[29] and to expand the scope of the implied covenant of good faith and fair dealing.[30] Suffice it to say that the recent surge of the unconscionability doctrine in California and the Ninth Circuit is the latest chapter in this saga and, regardless of the ultimate outcome, franchisees and franchisors are likely to spend substantial time and money litigating the doctrine in the coming years as they have in the past with respect to other "franchise fairness" arguments.

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V. THE RECENT CALIFORNIA ADR CASES

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VI. MATTERS OF PERSPECTIVE

A. <u>Is Arbitration the Problem?</u>

Is it possible that unconscionability's long dormancy, and now its possible resurgence, have more to do with fluctuating judicial attitudes towards arbitration, as opposed to judicial attitudes toward unconscionability itself? Referring to the many long years in which unconscionability was the argument of last resort, at least one commentator had previously linked "unconscionability's fall from grace and arbitrations' ascendance."[31] This connection has some logical appeal, given the current climate in California and the Ninth Circuit where the rise

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[27] *Id*. at 662.

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

[29] *See, e.g.*, Bixby's Food Sys., Inc. v. McKay, 985 F. Supp. 802, 808 (N.D. Ill. 1997) (franchise relationship does not create fiduciary relationship); Picture Lake Campground, Inc. v. Holiday Inns, Inc., 497 F. Supp. 858, 869 (E.D. Va. 1980) ("A franchise relationship is inherently a business relationship, not a fiduciary relationship").

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

[31] Stempel, *supra* note 25, at 764.

and fall are arguably reversed or in the process of reversing.[32] Interestingly, some franchisors have also begun to lose enthusiasm for arbitration.[33]

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

In once sense, there is clearly a "lack of meaningful choice" with respect to many or most franchise agreement terms, at least when dealing with established franchisors, which do not usually negotiate the terms of their franchise agreements. Courts have therefore sometimes found that franchise agreements are "contracts of adhesion."[34] However, even franchisee advocates must admit that, before signing the first franchise agreement, a prospective franchisee still has the choice of not signing at all, as becoming a franchisee is not usually considered a "necessity" of life. Also, the prospective franchisee can certainly compare contract terms in shopping among different franchise systems, although on this point, many franchisee advocates have complained that too many harsh terms have become prevalent. In any event, the franchisee always has some significant degree of choice in deciding whether to become a franchisee in any particular system. Accordingly, a franchisor's mere refusal to negotiate standard terms in its franchise agreement is rarely deemed sufficient to establish unconscionability.[35] Thus, most courts have concluded that the standard form nature of contracts, without more, does not *necessarily* make them unconscionable (and in the opinion of many franchisor attorneys, a standard form of contract, standing alone, should *never* suffice to establish unconscionability -- if this were enough, companies would be compelled to negotiate every contract individually, and organized business as we know it would grind to a halt).

C. The Problems of Characterization

By now, it should be clear to all that the doctrine of unconscionability, an equitable doctrine that judges (rather than juries) must apply, has been inconsistently applied and widely criticized. The question of procedural unconscionability invites subjective judicial *characterization*: In just about every case, the courts make "findings" as to the character of the parties, the transaction process, and the contract terms. Thus, findings of unconscionability

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[32] Adding support to this conclusion, recent Forums have included programs that substantially question the wisdom of mandatory arbitration from the franchisor standpoint.

[33] At the Forum in 2005, the merits of arbitration, from the franchisor perspective, were openly questioned, as it was observed that:

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

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

[34] *See*, Appendix 4 for a list of representative cases.

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

tend to occur when the franchisor is "strong," the franchisee is "weak," and both the process and the resulting contact terms are "unfair." All of this creates the risk of result-oriented decisions.

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

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

1. **<u>The Franchisee as "Employee"</u>**

Against the backdrop of growing franchisee attempts to bargain collectively, we review the question of whether courts are likely to follow the lead of cases such as *Mailbox Owners,* in which the court also likened franchisees to employees. Whether franchisees are comparable to employees is frequently an issue in litigation over covenants not to compete. However, the results outside of California are not encouraging to franchisees. In many states, covenants not to compete are disfavored when signed by employees, but favored when signed in the "sale of business".[36] Therefore, courts are often called upon to decide whether franchising more closely resembles an employment relationship or a sale of a business. The majority of courts that have addressed this issue have resolved it against the franchisee, with the "sale of business" characterization prevailing over the employment analogy, based largely on the transfer of goodwill from the franchisor to the franchisee, and the legitimate need to protect that goodwill from competition.[37] The likely reluctance of other jurisdictions to embrace the *Mailbox Owners* view of franchising as akin to employment is an obstacle that franchisees seeking to invoke *Mailbox Owners* will have to overcome.[38]

2. **<u>The Franchisee as "Consumer"</u>**

Franchisees may also continue to argue that they are analogous to "consumers," since the Federal Trade Commission arguably treats franchisees as consumers for purposes of its

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[36] See generally the discussion of non-competition agreements in franchising set forth in KLARFIELD, COVENANTS AGAINST COMPETITION IN FRANCHISE AGREEMENTS (2d ed. 2003).

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

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

regulation of the sales process,[39] and franchisees typically have standing under state consumer fraud laws.[40] Franchisees making the consumer argument should present evidence of the ways in which their franchisor brought the franchise to market, as franchise opportunities are typically advertised extensively in a manner comparable to the consumer marketing of products and services. However, while *some* franchisees might experience greater success in the future arguing that they are consumers for purposes of unconscionability claims, the problems of generalization among widely varying franchisees, discussed above, will remain. This problem was illustrated by the dissent in *Ticknor*, which argued vigorously that the owner of two hotels was not a consumer "under any definition of the term."[41]

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

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

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

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

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[39] The franchise sales process is regulated by the Consumer Protection Bureau of the FTC. *See* http://www.ftc.gov/ftc/consumer.htm (follow link for "Franchise & Business Opportunities"), and http://www.ftc.gov/bcp/menu-fran.htm.

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

[41] Ticknor v. Choice Hotels Int'l, Inc., 265 F.3d 931, 942-43 (9th Cir. 2001) (Tashima, J., dissenting).

3. Characterization Can Be Outcome Determinative

How a court chooses to characterize a franchisee can be outcome-determinative. In *We Care Hair*, the Seventh Circuit summarily held in 1999 that fifty-three hair-cutting franchisees were "not vulnerable consumers or helpless workers but rather business people who bought a franchise" without discussing the particular economic circumstances or business experience of any single franchisee.[42] There is simply no indication from the Seventh Circuit opinion that either side presented any evidence on these issues, aside from the undisputed evidence that the franchisees had purchased franchises and signed franchise agreements, which the court apparently found sufficient to remove them from the realm of consumers or employers.

Contrast the holding of the Seventh Circuit in *We Care Hair* with the California appellate opinion in *Mailbox Owners*, where the court opined that "the franchise factual context is sufficiently similar to mandatory employer/employee arbitration [and] consumer arbitration," leading to a pro-franchisee outcome.[43] In support of this finding, the franchisees had cited previous California decisions that had also described the franchise relationship as typically presenting unequal bargaining power, but nowhere does it appear that evidence of procedural unconscionability was actually presented in *Mailbox Owners*.[44] Characterization carried the day.

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

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

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[42] We Care Hair Dev., Inc. v. Engen, 180 F.3d 838, 843 (7th Cir. 1999) (internal quotations and citations omitted).

[43] *Compare id.* at 843 *with Mailbox Owners*, *supra* note 142, at 676.

[44] *Petition for Writ of Prohibition, Mandate and/or Other Appropriate Relief* at 55-57, *Mailbox Owners*, *supra* note 142 (No. GIC 814146) (citing Keating v. Super. Ct., 645 P.2d 1192, 1196 (Cal. 1982); E.S. Bills, Inc. v. Tzucanow, 700 P.2d 1280, 1288 (Cal. 1985); Postal Instant Press, Inc. v. Sealy, 51 Cal. Rptr. 2d 365, 373 (Cal. Ct. App. 1996)). The authors thank Forum Members Peter Lagarias and Michael Hankes for supplying a copy of the franchisees' Petition for Writ in *Mailbox Owners*, and likewise thank Forum Member Barry Heller for supplying a copy of the franchisors' responses.

> argument concerning inequality of bargaining power during execution of the agreement.[45]

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

D. <u>The Potential for Inconsistency</u>

Among the most troubling potential problems arising from characterization-based decisions are inconsistent results. Is a publicly-traded multi-unit, multi-system corporate franchisee in the need of the same protection as an individual who has not gone to college and is buying his or her first small business franchise? Perhaps not. Likewise, is a small but successful business trying to sell its first franchise in the same position as a "large wealthy international franchisor"?[46]

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

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

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

However, despite our expressed enthusiasm for actually presenting evidence, it is difficult to imagine that courts will actually want to hold trials in which the central issue, having survived summary judgment, is whether the particular franchisee had sufficient economic

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[45] Days Inns Worldwide, Inc. v. Mehta, No. CV 304-092, 2005 U.S. Dist. LEXIS 20803, at *12-13 (S.D. Ga. Sept. 7, 2005).

[46] Bolter v. Super. Ct., 104 Cal. Rptr. 2d 888, 893 (Cal. Ct. App. 2001) (accepting the franchisee's characterization of the franchisor and noting that the franchisor "made no attempt to refute [that] characterization").

capacity to agree intelligently to provisions that would be "shockingly unfair" absent the franchisee's wealth and experience. These issues are likely to be resolved summarily by motions, which will also tend to yield arbitrary results. So far, the unconscionability cases have not seriously grappled with the growing phenomenon of the economically sophisticated franchisee or the resulting potential for inconsistent results.[47]

E. **The "Market Power" Contradiction**

The *Ticknor dissent* lamented that the majority found unconscionability despite the lack of evidence that the franchisees were without meaningful alternatives, *i.e.*, that they could not have entered into an agreement with a different hotel franchisor.[48] This observation raises interesting questions as to whether courts should look to "tying" cases under Section 1 of the Sherman Act, 15 U.S.C § 1, when analyzing franchisees' unconscionability claims.

In tying cases, courts have consistently held that franchisors lack sufficient "market power" in the tying product (their franchises) to compel franchisee purchases of a "tied" product, *e.g.* a particular soft-drink to be served in a quick service restaurant[49] or the ingredients for a pizza.[50] In these cases, the courts have flatly rejected the contention that, at the time of the franchise sale, the franchisor has sufficient economic power to impose its will upon a new franchisee, by dictating the terms of the franchise agreement. For example:

> The important economic distinction that must be made is between pre- and postcontract economic power. Precontract, competition among franchisors (such as McDonald's or Kentucky Fried Chicken) to sign up franchisees prevents [a single franchisor] from exercising any economic power in setting contract terms with potential franchisees. [The franchisor], although it possesses a trademark, does not possess any economic power in the market in which it operates -- the fast food franchising (or perhaps, more generally, the franchising) market.[51]

Likewise:

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

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

[48] Ticknor v. Choice Hotels Int'l, Inc., 265 F.3d 931, 942-43 (9th Cir. 2001) (Tashima, J., dissenting).

[49] Martino v. McDonald's Sys., Inc, 625 F. Supp. 356 (N.D. Ill. 1985).

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

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

> We are talking about a market in which there is competition for new franchisees. Obviously there is almost invariably disparate economic power between a franchiser and an already existing single franchisee, although the cooperative efforts of franchisees may more evenly balance that economic power; and the self interest of the franchiser which, after all, must seek more franchises and keep existing franchisees relatively satisfied, may mute the exercise of power. That disparity has led to both state and federal legislation to curb franchise abuses, and the introduction of some restraints upon pain of termination may well violate the antitrust laws. Here, however, we are dealing with requirements which always, or at least for many years, have been part of the franchise agreements.[52]

We omit discussion of the ways in which franchisees might attempt to prove market share. Suffice it to say that these holdings are very difficult, if not impossible, to reconcile with the contrary premise of the unconscionability doctrine, which is that, in cases where the court accepted the franchisee's claim of unconscionability, the franchisor allegedly had sufficient "economic power in setting contract terms with potential franchisees."[53] Courts may eventually have to confront this contradiction. So far, the courts have largely avoided the issue by focusing more on the process of negotiation -- *e.g.,* the refusal to bargain or other tactics that franchisees often find high-handed, rather than the franchisor itself. In *Weaver v. American Oil*,[54] for example, evidence that an oil company neither explained the provisions of an agreement prepared by its attorneys to a poorly-educated gas station operator nor advised the latter to seek legal counsel led the court to conclude that the superior bargaining power of the oil company was "patently obvious."[55]

On this score, it is worth recalling how certain California courts have avoided confronting this issue by holding, in essence, that procedural unconscionability is present whenever the franchise agreement is classified as an adhesion contract."[56] The "market power" line of tying cases presumably would contradict the notion that anyone was "forced" to buy any particular franchise, or to accept any particular clause in their franchise agreement.[57]

The Seventh Circuit has already rejected the notion that "franchisees were *forced* to swallow unpalatable terms" in the franchise acquisition process, but it has thus far reached this conclusion by characterizing the franchisees as independent business persons, not by focusing on the franchisor's alleged market power.[58]

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[52] *Martino*, 625 F. Supp. at 361.

[53] *Queen City*, 922 F. Supp. at 1061 (quoting Klein*, supra* note 227).

[54] 276 N.E.2d 144, 146 (Ind. 1971).

[55] *Id*.

[56] *See,* Leff, *supra* note 10, at 504-06.

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

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

F. Renewing Franchises And Market Power Issues

Consider the dilemma faced by a franchisee whose initial agreement provides for renewal only as long as certain conditions are met, and only upon execution of the franchisor's "then-current" form of agreement. If, upon renewal, the franchisee is presented with materially different terms than had been contained in the original franchise agreement, the element of "choice" in accepting the new terms is arguably illusory, as the renewing franchisee is hardly in position to walk away from its substantial equity investment. In this situation, the franchisor effectively has a captive market. In *Martino v. McDonald's*, the district court specifically noted that "[o]bviously, there is almost invariably disparate economic power between a franchiser and an already existing single franchisee, ..."[59] Similarly, the *Bolter* court's unconscionability finding relied, at least in part, on the fact that the disputed arbitration provision was added during the renewal process after the franchisees were already "locked in" with a particular franchisor.[60] The courts' language in these cases certainly suggests that a renewing franchisee might potentially fare better than a new franchisee on the issue of procedural unconscionability. The renewal issue could very well serve as a potent weapon for franchisees seeking to challenge the new terms of their agreements as unconscionable, but only, it would seem, where the terms challenged had not been part of the original franchise agreement.

G. The Effect of Franchisee Associations

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

> the cooperative efforts of franchisees may more evenly balance that economic power; and the self interest of the franchiser which, after all, must seek more franchises and keep existing franchisees relatively satisfied, may mute the exercise of power [by the franchisor].[61]

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

There may well come a day when franchisee collective bargaining efforts provide the death knell for unconscionability in franchising, but that day has not arrived. Until then, two conclusions are reasonably drawn. First, success at the bargaining table, and not successful

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[59] Martino v. McDonald's Sys., Inc., 625 F. Supp. 356, 361 (N.D. Ill. 1985).

[60] Bolter v. Super. Ct., 104 Cal. Rptr. 2d 888, 894 (Cal. Ct. App. 2001).

[61] 625 F. Supp. at 361.

unconscionability challenges, should remain the ultimate guide for franchisees and their advocates. For franchisees, unconscionability challenges are perhaps best viewed as incentives for franchisors to negotiate, albeit the strength of this incentive is not yet known. Second, as the doctrine of unconscionability evolves, and as more franchisees attempt to negotiate with their franchisors, we predict less "characterization" and more evidence, as to the relative strength and sophistication of the contracting parties and the contract formation process, in support of, and in opposition to, particular unconscionability challenges.

H. Problems in Substantive Unconscionability

1. "Business Reality" -- the System or the Individual Franchisee?

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

However, some of those clauses might arguably be viewed as benefiting other franchisees in the system who are not in dispute with the franchisor. To be sure, franchisees can still argue that clauses that serve to limit franchisee remedies remain destructive to franchising, by encouraging bad behavior on the part of some franchisors, but the point for the purposes of discussing substantive unconscionability is whether such clauses cross the line and "shock the conscience" etc., or whether they are at least defensible risk reduction strategies arguably benefiting the entire system, such that courts should be reluctant to disturb the parties' express allocation of risks. In the cases thus far, we have not seen this argument made. The "business reality" subject is another area in which expert testimony might be expected to help determine which contract provisions arguably protect the entire system, including the franchisor, and which can rightly be viewed as benefiting *only* the franchisor.

2. Unfair, Incomplete, or Ambiguous?

Justice Sandra Day O'Connor has observed that "a determination that a contract is 'unconscionable' may in fact be a determination that one party did not intend to agree to the terms of the contract."[62] More often, perhaps, a franchisee will acknowledge agreement with the express terms, as written, but sharply disagree with the franchisor's later interpretation or implementation of those terms. Arguably, franchisees suffer more unfavorable outcomes as the result of franchisor conduct in the face of contract provisions that were incomplete or ambiguous at the time of contracting. Some examples:

- An agreement provides that the franchisor shall not open any competing stores within a defined franchise territory. Is the franchisor barred from soliciting Internet sales in the territory? Mail order sales? What do the words "shall not open a store" really mean?

- An agreement provides that the franchisor agrees to "furnish national account leads" to the franchisee. What does it mean to "furnish" a business "lead?" How is a "national account" defined, absent a definitional clause elsewhere in the agreement?

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[62] Am. Airlines v. Wolens, 513 U.S. 219, 249 (1995) (O'Connor, J., concurring in the judgment in part and dissenting in part).

Is the "duty" to "furnish national account leads" change when the franchisee has a defined territory in which it might attempt to service a national account?

- An agreement provides that the franchisor may designate sources of supply. From this language alone, is the franchisor able to derive a profit in the form of supplier rebates? If the rebate is permitted, because among other things it was disclosed in the Offering Circular, is there any limit on the amount of the rebate, or the price that the franchisee may be charged? Can the resulting charges to the franchisee exceed market prices?

- An agreement provides that the franchisor may terminate the franchise agreement without notice and without opportunity to cure, on the occurrence of multiple defaults or violations of the agreement, but without requiring that any of the accumulated prior defaults or violations be "material."

In each of these examples, the franchisee is vulnerable to an unfavorable outcome, resulting from the wide-open language that the parties "bargained for." Moreover, the franchisee's post-contracting vulnerability to unfavorable outcomes, based on the franchisor's opportunity to interpret loose contract language in a self-serving way, is heightened by the fact that, after the sale, the franchisee considering a challenge is now invested in the particular franchise, and vulnerable to termination and the possible loss of equity.[63]

For franchisees, is unconscionability the best argument for challenging clauses that are ambiguous or incomplete? The answer may be "yes" when they have the benefit of a statute that proscribes unconscionable *conduct*, as indicated by the summary of "franchisee successes" in Section IV.E., *supra.* However, if no such statute proscribing unconscionable conduct is available, then franchisees may be left trying to make new law -- *i.e.,* a post-sale doctrine of "unconscionable conduct" or "unconscionable results." Such a doctrine will certainly meet wide and deep resistance as an attempt to resurrect a broad fiduciary duty. Therefore, for the foreseeable future, franchisees must continue to resort to claims based upon the implied covenant of good faith and fair dealing, for it is not clear that the doctrine of unconscionability will reach contract terms that create the potential for unfair results, which contradict the franchisee's reasonable expectations at the time of contracting, as opposed to being unfair on their face.[64]

Other commentators have reached the same conclusion, based on the observation that franchise agreements are relational contracts -- contracts that require mutual performance over a number of years. Accordingly, they are necessarily incomplete in defining the parties' precise duties in every situation, and necessarily vest discretion, especially in the franchisor, as to

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[63] *See, e.g., Martino*, 625 F. Supp at 361 (carefully distinguishing between the franchisor's pre-sale and post-sale powers to impose harsh results on franchisee).

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

exactly how the agreement will be performed over a period of years.[65] As observed in an influential 1990 Law Review article critical of franchisors and popular with franchisee lawyers:

> Courts have experimented with a number of other doctrinal tools. Doctrines of adhesion, unconscionability, and fiduciary duty have all had brief lives in the franchising context . . . . Most courts . . . have rejected all of these approaches to resolving franchise disputes, largely because these doctrines appear overly protective outside of the consumer context and because they cut too broadly, often resulting in an unenforceable contract. The essential element of inequality in franchising highlights another reason why these doctrines are inappropriate: They operate from the premise that the problem arises from the unequal bargaining power between franchisor and franchisee at the time the contract is 'negotiated.' However, the difficulties in franchising arise in the ongoing exercise of power in the gaps of the incomplete contract. While contracts could certainly be less one-sided, they could not be significantly less incomplete.[66]

3. Efforts to Abolish Good Faith and Fair Dealing

The Ninth Circuit recognized, in *Chodos v. West Publishing Co.*, that the covenant of good faith and fair dealing makes discretionary promises real, and prevents the voiding of contracts for lack of mutuality.[67] Coming full circle, increasing efforts by franchisors to eliminate or reduce application of the doctrine of good faith and fair dealing to franchise agreements may spur unconscionability challenges.[68] If franchisors succeed in imposing waivers of the implied covenant, which some franchisors have attempted to do, franchisees may find that they are left without remedy for franchisor conduct that they find unfair when the franchise agreement does not explicitly prohibit that conduct. Nature abhors a vacuum, and so do most lawyers and judges. The absence of the implied covenant, or other "standards of care" by which to measure the adequacy of the franchisor's performance of its duties under the franchise agreement, can make the franchisor's promises illusory, and the enforceability of the franchise agreement may be called into question.

VII. CONCLUSION

The doctrine of unconscionability appears to be in a state of flux, and it has yet to be determined what effect the recent California and Ninth Circuit cases will have on future decisions in those jurisdictions, and whether and how the impact of those decisions will extend elsewhere. However, the First Circuit's recent *Kristian* decision, in which a court thousands of miles from California and the Ninth Circuit struck down provisions precluding class arbitration and damage provisions because they frustrated the vindication of statutory rights, should make

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

[66] Hadfield, *supra* note 241, at n.262.

[67] 292 F.3d 992, 996-97 (9th Cir. 2002).

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

all franchise lawyers sit up and take notice. Franchisee counsel may want to consider raising arguments long ago abandoned, and franchisor counsel should not be as dismissive of unconscionability attacks as they may have become. A new day dawning? It is too soon to tell, but we should all keep our eyes on the horizon.

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APPENDIX 1

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

APPENDIX 2

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

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

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

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

Alabama (Ala. Code § 8-19-5(27));

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

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

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

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

Michigan (Mich. Comp. Laws § 445.903);

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

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

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

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

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

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

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

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

APPENDIX 3

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

APPENDIX 4

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

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

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

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

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

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

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