# Having It Both Ways: Can a Franchisor Insist on Arbitration and Litigation?

By William Sentell, Gardere Wynne Sewell LLP

Many franchise agreements include mandatory arbitration clauses, and litigation over the enforceability of such provisions is quite common. *See*, generally, Drafting an Enforceable Franchise Agreement Arbitration Clause, 22 Franchise L.J. 112 (2002). Arbitration can have distinct advantages over litigation and, when deployed strategically, it can minimize costs that are ultimately absorbed by franchisors and franchisees alike. Additionally, compared to judicial proceedings, franchisees seeking damages and other relief may prefer arbitration because of its relative speed, flexibility and informality.

Arbitration is rarely a "one size fits all" proposition. In fact, most arbitration agreements contain exceptions that permit a franchisor to seek judicial remedies in some limited circumstances, without affording reciprocal rights to the franchisee. Issues may arise when litigation and arbitration are both available to a franchisor. Ultimately, the issue boils down to the franchisor's desire to "have it both ways." In the most extreme example, the potential right to pursue claims in judicial and arbitral forums may create a perception of overreaching and lead to unwanted litigation.

This article is intended to illustrate two related issues that may arise in any "hybrid" dispute resolution program. In the first scenario, the franchisor reserves the right to insist on litigation for some, but not all claims. In the second scenario, the franchisor retains the right to elect arbitration or litigation with respect to any claim. Both scenarios require careful consideration of state law principles related to contractual formation, mutuality and overall fairness.

## Generally: Mutuality in Arbitration Agreements

Black's Law Dictionary defines mutuality of obligation as "the agreement of both parties to a contract to be bound in some way." Mutuality of Obligation, Black's Law Dictionary 1046 (8th ed. 2004). Generally speaking, there is no requirement that both parties undertake identical obligations, provided that there is sufficient consideration for the contract as a whole. Restatement (Second) of Contracts § 79 (Am. Law Inst. 1981) ("If the requirement of consideration is met, there is no additional requirement of . . . equivalence in the values exchanged; or . . . 'mutuality of obligation.'"). Most courts facing the issue of non-mutuality in franchise arbitration clauses have concluded that consideration for the entire contract is sufficient to support the arbitration clause. *See, e.g.*, *Doctor's Assocs., Inc. v. Distajo*, 66 F.3d 438, 452 (2nd Cir. 1995) (collecting cases).

Notwithstanding the general rule, courts may take a dim view of arbitration agreements that appear to significantly favor one party over the other. Courts analyzing such arbitration provisions will typically apply substantive state-law principles to determine threshold issues of contractual formation and enforceability. Assessing the contract on these narrow grounds is generally permitted under the Federal Arbitration Act ("FAA"), provided the underlying state law does not serve to "single out" an arbitration agreement or create an "obstacle" to their enforceability. See 9 U.S.C. § 2 ("A written provision in any maritime transaction or a contract evidencing a transaction involving commerce to settle by arbitration a controversy thereafter arising out of such contract or transaction . . . shall be valid, irrevocable, and enforceable, save upon such grounds as exist at law or in equity for the revocation of any contract."); *AT&T Mobility LLC v. Concepcion*, 563 U.S. 333, 339 (2011) ("[A]greements to arbitrate [may] be invalidated by 'generally applicable contract defenses . . .' but not by defenses that apply only to arbitration or that derive their meaning from the fact that an agreement to arbitrate is at issue." (quoting *Doctor's Assocs. v. Casarotto*, 517 U.S. 681, 687 (1996)).

## Scenario One: The Litigation "Carve-Out"

Most arbitration agreements in franchise contracts include a carve-out for claims seeking injunctive relief. The most obvious examples are claims involving restrictive covenants, such as enforcement of a non-compete covenant or protection of intellectual property rights. In *Meadows v. Dickey's*

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*Barbeque Restaurants*, for example, the franchisor successfully argued that its arbitration agreement, which included a litigation carve-out, was not substantively unconscionable under Texas law. 144 F. Supp. 3d 1069, 1087 (N.D. Cal. 2015). That arbitration agreement allowed the franchisor to institute litigation for monies owed, injunctive relief, and claims involving real property. The court held that "[a]lthough Dickey's reservation of the right to litigate certain claims lacks mutuality, under Texas law this 'allocation of risk because of superior bargaining power' is not so one-sided to render the arbitration provision unconscionable." *Id.* (quoting In re *FirstMerit Bank*, N.A., 52 S.W.3d 749, 757 (Tex. 2001)).

The *Meadows* court relied on a line of Texas Supreme Court cases holding that a litigation carve-out in an arbitration agreement is enforceable, provided that it serves the "commercial needs" of the party seeking litigation. Id. (citing In *re FirstMerit Bank*, 52 S.W.3d at 757). Here, and elsewhere, discussion of what constitutes "commercial needs" for purposes of allowing the carve-out is relatively sparse. But the implication is that, in order to vindicate certain rights, and maintain the integrity of its business model, a franchisor (or other commercial party) needs to retain access to a judicial forum for at least some types of claims.

Indeed, one cited reason for allowing litigation is that an arbitrator may lack the practical ability to award certain extraordinary remedies. In *Berent v. CMH Homes*, the plaintiff had purchased a manufactured home. 466 S.W.3d 740 (Tenn. 2015). Believing his home to be defective, the buyer filed suit against the sellers in Tennessee state court. The sellers responded with a motion to compel arbitration. *Id.* at 742. The buyer argued, inter alia, that the seller's ability to institute judicial foreclosure proceedings meant that the arbitration agreement lacked mutuality and was unconscionable. *Id.* In rejecting that argument, the Tennessee Supreme Court focused on the "reasonable business justification" for allowing the carve-out in the first place. *Id.* at 758. It noted that, under applicable arbitration rules, the seller lacked the practical ability to institute foreclosure proceedings and thereby protect its collateral. *Id.* at 756–57. But see American Arbitration Association, Commercial Arbitration Rules, R. 37 (granting arbitrators the power to award interim relief, including for the "protection or conservation of property"). Accordingly, the Berent court held that the arbitration agreement did not unreasonably favor the sellers and was not oppressive or unconscionable. *Id.*

While the cases discussed above suggest that enforcement of the litigation carve-out is relatively straightforward, courts also consider overall fairness in analyzing these types of provisions. A number of courts have considered whether, by insisting on litigation for some claims, the franchisor has waived the right to defend the same types of claims in arbitration.

In *Eaton v. CMH Homes*, the buyer of a manufactured home brought an action against the seller for fraud, negligence, breach of contract, and misrepresentation and the seller filed a motion to compel arbitration under the parties' agreement. 461 S.W.3d 426, 431 (Mo. 2015) (en banc). The buyer opposed arbitration, arguing that the arbitration agreement lacked mutuality and was unconscionable on multiple grounds. *Id.* at 429. In particular, the buyer pointed out that he was required to submit all claims to binding arbitration, whereas the seller reserved the right to bring suit in court to "foreclose upon any collateral, to obtain a monetary judgment or to enforce the security agreement." *Id.*

In the buyer's view, this meant that the contract lacked mutuality. In rejecting that argument, the Missouri Supreme Court articulated the general rule that, as long as the contract as a whole meets the consideration requirement, an arbitration clause in the contract will not be invalidated for lack of mutuality. *Id.* at 434 (citing *State ex rel.Vincent v. Schneider*, 194 S.W.3d 853, 858–59 (Mo. 2006)). Nevertheless, it significantly undercut its holding when it also ruled that the anti-waiver provision in the arbitration agreement (which allowed the seller to litigate certain claims without giving up the right to arbitrate the same underlying controversy) was itself unconscionable. *Id.* at 435. Of particular concern to the court was the fact that the seller could "bring suit on the key financial issues of importance to it" yet the buyer "is prohibited from defending these claims in court and risks inconsistent adjudications, or the application of res judicata or collateral estoppel, should he try to file an arbitration claim in which he brings up these defenses, even assuming this is possible." *Id.* at 436. Ultimately, the court relied on the contract's severability clause to strike the anti-waiver language. *Id.* In effect, if the seller instituted any claims in litigation, it would be required to defend any compulsory counter-claim in a judicial forum.

Similarly, in *Perez v. DirectTV Group Holdings, LLC*, the small business owner plaintiff, brought a putative class action against DirecTV. 251 F. Supp. 3d 1328

(C.D. Cal. 2017). The plaintiff alleged that DirectTV and others had engaged in a scheme whereby they would sell commercial satellite cable services, only to later claim that the businesses were not authorized to display television services in a commercial establishment. *Id.* at 1335. DirecTV argued not only that the purchasers agreed to submit all claims to arbitration, but also that DirectTV reserved the right to institute litigation for claims related to "theft of services." *Id.* at 1346–47. In the court's view, this meant that DirecTV could sue for unauthorized use of cable services, but any customer counterclaim alleging that such right is invalid as part of a fraudulent scheme must be arbitrated. *Id.* at 1346. Applying California's substantive unconscionability law, the court found that "the lack of mutuality is abundantly clear" and refused to require the plaintiff to submit her claims to arbitration. *Id.*

Critically, the court rejected DirecTV's argument that the FAA preempted any examination of the bilateral nature of an arbitration agreement in evaluating a contract's substantive unconscionability. *Id.* at 1349. It noted that California also deems unconscionable one-sided fee-shifting agreements in favor of the drafter of a contract of adhesion. *Id.* The implication was that the court was not singling out arbitration agreements, but that it was simply policing the fairness of any one-sided agreement. In the court's words, "California's substantive unconscionability doctrine, if it has any pronounceable effect, encourages arbitration by preventing a party with superior bargaining power from exempting itself entirely from the arbitration provision it imposes on its customers." *Id.*

The *Perez* court's analysis regarding the effect of the litigation carve-out raises an important strategic consideration: whether a party can credibly justify the need for one-sided litigation in a particular case. Applied to the franchising context, the rationale for a litigation carve-out is arguably stronger as it relates to injunctive and other provisional relief. The rationale is arguably weaker with respect to claims for unpaid royalties and other monetary claims since the franchisor would usually insist on arbitration if it were defending those types of garden variety damages claims for breach of contract. In the latter scenario, the franchisor arguably runs the risk that, by instituting litigation (or even threatening litigation), it has effectively waived the right to arbitrate the franchisees' claims arising out of the same transaction.

In short, while there is no overriding prohibition against litigation carve-outs, courts are likely to consider the breadth of the carve-outs in determining the enforceability of the underlying agreement to arbitrate. Drafters and litigants should therefore carefully consider which claims are being exempted from arbitration and why those claims are being exempted.

## Scenario Two: Optional Arbitration Agreements

In the first carve-out scenario, the franchisor is stating in advance which claims it intends to litigate and which claims must be arbitrated. In the second scenario—where arbitration is purely optional—the franchisor is deferring the decision. On one hand, deferring the decision to litigate or arbitrate offers some strategic advantages, such as when a particular state's relationship laws prohibit the franchisor from requiring out-of-state litigation. On the other hand, enforcing an optional arbitration agreement invites some of the same contractual formation questions that are characteristic of the carve-out scenario. Here, the primary issue is whether the promise to arbitrate is illusory.

A case from the Seventh Circuit involving Steak 'n Shake is illustrative. *Druco* Restaurants, *Inc. v. Steak N Shake Enterprises*, 765 F.3d 776 (7th Cir. 2014). In *Druco*, several franchisees signed franchise agreements that purported to allow the franchisor, Steak 'n Shake, to "institute a system of nonbinding arbitration or mediation" at any time. *Id.* at 779. When a dispute over mandatory menu pricing erupted, several franchisees filed lawsuits in the federal district court in Indiana. Steak 'n Shake responded by adopting a policy requiring the franchisees to engage in nonbinding arbitration at Steak 'n Shake's request. It then sought to compel arbitration. *Id.*

The district court ruled that, under Indiana law, Steak 'n Shake's purported optional arbitration agreement amounted to an illusory promise. *Id.* at 782. The lower court noted that there was no limit on Steak 'n Shake's ability to arbitrate (or avoid arbitration) on its own whim. *Id.* at 779. The U.S. Seventh Circuit affirmed, and stressed further that the language at issue was simply too "vague and indefinite" to "demonstrate the existence of valid agreements to arbitrate." *Id.* at 784.

The Fifth Circuit reached a similar conclusion in *Morrison v. Amway Corp.*, 517 F.3d 248 5th Cir. 2008. There, the court refused to enforce an

optional arbitration provision contained in a distributorship agreement. The court concluded that there was "nothing in any of the relevant documents which preclude[d]. . . eliminating the entire arbitration program or its applicability to certain claims or disputes so that . . . mandatory arbitration would no longer be available even as to disputes which had arisen and of which Amway had notice prior to publication [of the change]." *Id.* at 257.

The underlying issue in both *Druco Restaurants* and *Morrison* was whether a party may retroactively impose arbitration or renege on its promise to arbitrate. In both instances, the agreement to arbitrate was deemed to be illusory and therefore unenforceable. This is consistent with the FAA, which applies to any "written provision . . . to settle by arbitration a controversy thereafter arising out of such contract or transaction . . . ." 9 U.S.C. § 2 (emphasis added). Simply put, there is no federal policy favoring the enforcement of "inchoate" arbitration agreements. Accordingly, franchisors should consider whether, by retaining the option to arbitrate future claims, they are unwittingly giving up the right to arbitrate at all.

## Conclusion

Flexibility in arbitration agreements certainly has its advantages from the franchisor perspective. But too much flexibility may result in unwanted litigation over arbitration: exactly the result that a well-drafted arbitration provision is intended to avoid. Franchisors should use litigation carve-outs thoughtfully and sparingly to preserve the enforceability of the dispute resolution program. Moreover, franchisors should elect to require arbitration at the outset of the relationship, and well before any disputes arise. ■

# MEMBER SPOTLIGHT

## VAN THIET LAM

Van Thiet Lam
Regal Nails, Salon & Spa, LLC

**OFFICE LOCATION:** Baton Rouge, LA.
**PRACTICE SPECIALTY:** As an in-house legal department of one, I don't really have a specialty, except maybe franchising. I deal with corporate governance, employment, vicarious liability, ethics issues involving conflicts, privilege and confidentiality issues, and trademarks and copyrights. The bulk of my responsibility is reviewing, revising and drafting agreements, leases, subleases, and default and termination letters. And for some reason, I also get roped into dealing with non-legal matters in the office.
**HOBBIES:** Writing, sketching, and gaming.
**BEST-LOVED SONG:** This is a hard one. I don't have one particular song that is best loved. My taste in music is a bit eclectic. My favorite album is probably BNTH's E1999 Eternal. Linkin Park's Meteora is also good. But I also enjoy late 80's/early 90's music: Erasure, Roxette, Depeche Mode, Chris Issak's Wicked Game, Tears for Fears, Cause and Effect (the Trip album specifically), Richard Marx's Right Here Waiting… I can go on forever.
**FAVORITE THING ABOUT THE FORUM:** The collegial spirit of our community. Whether you're new or long in the tooth, all Forum members tend to be approachable and easy to have conversations with, whether the topic is franchising or not. The chance to annually meet back up with far flung friends for a couple of days is also great.
**SOMETHING PEOPLE WOULD BE SURPRISED TO LEARN ABOUT YOU:** I'm a Disney fan. My kids are only an excuse to go to Disney more often. I do get a kick out of seeing the way my daughter's eyes light up when she's meeting a character or waving at the princesses on parades and my son's smile as he makes Dumbo go up and down.
**IF YOU HAD MORE TIME, YOU WOULD:** Write more for fun. I'd like to get back to writing short stories on a more regular basis as well as tackle a novel one day.
**WHAT ARE YOU LISTENING TO NOW:** It depends on what I'm doing. When I'm working out or doing chores, usually it's an audiobook. If not an audiobook, it's usually This American Life or Radiolab. Music-wise right now I'm listening to mostly cover songs on the way to school for my kids.
**FAVORITE FORUM MEMORY:** Annual dinner at Harry Potter. Hands down. All the Harry Potter rides with no lines. Who wouldn't love that?