DISTRICT & FRANCHISE

Legal News Alert™

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Legal News Alert is part of our ongoing commitment to providing up-to-the-minute information about pressing concerns or industry issues affecting our clients and our colleagues.

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Federal Legislation Would Invalidate Arbitration Clauses in Franchise, Consumer, and Employment Agreements

Since 1925, when Congress enacted the Federal Arbitration Act (FAA), contractual provisions requiring binding arbitration of disputes have been "valid, irrevocable, and enforceable," unless legal or equitable grounds exist for revocation of the contract. 9 U.S.C. § 2. When seeking to avoid arbitration, claimants — including franchisees and dealers, consumers, and employees — often allege "fraud in the inducement." The case law is clear, however, that a party seeking to void an arbitration agreement has the burden of proving by clear and convincing evidence that that arbitration clause itself — not just the agreement of which it is part — was fraudulently induced.[i] Consistent with the federal policy in favor of arbitration reflected in the FAA, arbitration clauses are common in many franchise and distribution contracts, consumer contracts, and employment contracts.

Such arbitration provisions would become unenforceable — after the fact — if the so-called Arbitration Fairness Act of 2007 (Arbitration Fairness Act) becomes law. This legislation, introduced July 12, 2007, would invalidate pre-dispute agreements to arbitrate "franchise," "consumer," and "employment" disputes as defined by the statute.

"Franchise" disputes subject to the Arbitration Fairness Act would be defined as those arising under any contract whereby (1) a franchisee is granted the right to engage in business under a marketing plan prescribed in substantial part by the franchisor, (2) the operation of the franchisee's business is substantially associated with a commercial symbol such as a trademark or logo, which designates the franchisor or an affiliate of the franchisor, and (3) the franchisee is required to pay a franchise fee, either directly or indirectly.

"Consumer" disputes would be defined as those between a "person" and a seller or provider of property, services, money, or credit. To qualify as a "person," the

[i] *Prima Paint Corp. v. Flood & Conklin Mfg. Co.*, 388 U.S. 395, 403-404 (1967)

consumer could not be an organization. Only goods or services obtained for personal, family, or household purposes would qualify. Disputes about goods or services obtained for business purposes would not qualify as consumer disputes. A small business seeking to invalidate an arbitration clause could do so, however, if the agreement was between "parties of unequal bargaining power."

"Employment" disputes would be defined as those between employee and employer, as that relationship is defined in the Fair Labor Standards Act. The statute would not apply, however, to arbitration provisions in collective bargaining agreements.

Under current law, whether a particular claim is subject to arbitration is often determined by the arbitrator, unless a contrary intention to have a court decide that issue appears in the arbitration agreement.[ii] Under the Arbitration Fairness Act, courts applying federal law would decide the enforceability of arbitration provisions.

Because the statute would apply retroactively to contracts entered into before its enactment, the Arbitration Fairness Act would effectively rewrite existing contracts. It also would rewrite existing federal law by making the following "findings" about the current statute, the FAA, as interpreted by the courts:

1. The FAA was intended to apply to commercial entities of similar sophistication and bargaining power.
2. Various U.S. Supreme Court decisions have since broadened the applicability of the FAA to extend to parties of very disparate economic power, so that millions of consumers and employees must submit disputes to binding arbitration.
3. Many of these consumers and employees may not have understood the arbitration clauses in agreements they accepted, or had little choice in accepting the agreements.
4. Private arbitration companies often are under pressure to devise systems that favor paying corporate customers — a source of repeat business.
5. Mandatory arbitration implies no meaningful judicial review of arbitrators' decisions. This "undermines the development of public law for civil rights and consumer rights," and leaves arbitrators virtually free to "ignore the law and even their own rules."
6. Mandatory arbitration is not "transparent" unlike the judicial system, where written decisions are publicly available and decision-makers can be held accountable for their actions.
7. Many arbitration clauses contain provisions that "strip individuals of substantive statutory rights, ban class actions, and force people to arbitrate their claims hundreds of miles from their homes." Too many courts uphold "egregiously unfair mandatory arbitration clauses," because federal policy supposedly favors arbitration.

Under current law, only automobile dealers and other motor vehicle franchisees are exempt from the FAA, and only when they are challenging arbitration provisions in motor vehicle franchise agreements. (Many dealers require their customers to arbitrate all claims.) Under the Motor Vehicle Franchise Contract Arbitration Fairness Act (MVFCAFA), enacted in 2002, arbitration provisions in motor vehicle franchise agreements are enforceable "to resolve a controversy arising out of or relating to such contract … only if after such controversy arises all parties to such controversy consent in writing to use arbitration to settle such controversy." 15 U.S.C. § 1226(a)(2). Ironically, the rationale for the MVFCAFA would — if the Arbitration Fairness Act becomes law — be extended to contracts between motor vehicle franchisees and their customers.

[ii] *First Options v. Kaplan,* 514 U.S. 938, 943 (U.S. 1995)

Reasonable minds can and do differ as to the merits of arbitration as a method of alternative dispute resolution. Many franchisors and manufacturers, however, have made the business judgment that arbitration is preferable to litigation of disputes with franchisees, dealers, and distributors. In reliance on the long-standing federal policy in favor of arbitration reflected in the FAA, these franchisors and manufacturers have included arbitration provisions in their standard form franchise, dealer, and distribution contracts.

Because of the importance of arbitration clauses to many franchisors and manufacturers, Foley's Distribution & Franchise and Public Affairs Practices will be monitoring the progress of the Arbitration Fairness Act. The Senate version of the bill, S. 1782, was sponsored by Senator Russell Feingold (D-WI) and Senator Richard Durbin (D-IL). Its House of Representatives counterpart, H.R. 3010, was sponsored by Representative Hank Johnson (D-GA). The bills, S. 1782 and H.R. 3010, have been referred to the Senate and House Judiciary Committees, respectively.

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