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ENFORCEMENT OF ARBITRATION CLAUSES AGAINST DECEIVED FRANCHISEES

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Resolving the issue of fraud in the inducement of franchise agreements is an area that merits refinement. To save time and expense, arbitration—which bars both parties from the court system to resolve disputes—is a significant contemporary development. The reliance on arbitrators, who are not bound by precedent, is especially serious when their authority to resolve a particular controversy comes from a franchise agreement. Such agreements have been the subject of legislative inquiry, administrative action and litigation largely because of the informational imbalance between franchisors and franchisees during the course of negotiating their agreements. This article argues that, because franchisees generally are not able to understand the significance of relinquishing basic legal rights via a broadly-worded arbitration clause,[1] judges, not arbitrators, should resolve franchisees' allegations of fraud in the inducement.

Most disputes between franchisors and franchisees arising after the agreement is made will be resolved by arbitration, resulting in a final decision fashioned by arbitrators who are not bound by the doctrine of stare decisis. Considering the broad arbitration clauses in many franchise agreements together with recent court decisions compelling arbitration,[2] courts will decide only a few of the controversies between parties to franchise agreements. Generally, a party should be required to arbitrate when he has agreed to this alternative to litigation. However, arbitration is a questionable method for resolving a franchisee's claim that the franchisor's fraud induced

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1. *See, e.g.*, Atcas v. Credit Clearing Corp. of Am., 292 Minn. 334, 197 N.W.2d 448 (1972). After the contract had been negotiated and the franchisee had made payment pursuant to the agreement, the franchisor pointed out that any controversy regarding performance of the agreement would be arbitrated. The franchisor, however, said nothing about arbitration of any controversy which might arise out of representations made to obtain the franchisees' signatures on the franchise agreement. *Id.* at 337, 197 N.W.2d at 450.

2. *See infra* notes 45-69 and accompanying text.

him to enter the agreement.

Franchisors, experienced in the business of selling franchises, are sophisticated in enticing prospective franchisees to accept their terms on a "take it or leave it" basis, creating a contract of adhesion.[3] Thus, only after a controversy has actually arisen does the franchisee appreciate for the first time the differences between litigation and arbitration in protecting himself against misrepresentations that induced him to become a franchisee. Even if a few franchisees appreciate the significance of the arbitration clause, they may nevertheless agree to include the clause on the belief that the franchisor will not yield on the terms that he is offering.[4]

This article summarizes recent developments in federal and state law denying a franchisee his day in court despite his allegations of fraud. It argues that recent court decisions are ill-advised and ill-considered in light of certain realities surrounding the negotiation of franchise arrangements. The article takes the position that franchisees require greater protection than other parties who enter contracts that include agreements to arbitrate future disputes. It appears, however, that courts will not exempt franchisees from their recent holdings that enforce almost all types of promises to arbitrate. Although the courts' zealous, pro-enforcement policy preserves the major advantages of arbitration, a speedy and relatively inexpensive proceeding, this article notes some peculiarities of the franchise industry which indicate that judges, not arbitrators, should resolve the issue of fraud in the inducement.

I. Historical Perspective

For centuries the courts have protected persons against the fraud and deceit of other parties.[5] The earliest known case involved the misuse of legal procedure to swindle someone.[6] Because a contract induced by fraud is voidable and the arbitration clause is part of an agreement allegedly induced by fraud, the threshold issue of fraud must logically be resolved prior to arbitration of

3. *See Atcas*, 292 Minn. at 337, 197 N.W.2d at 450.

4. *See, e.g.*, Pinkis v. Network Cinema Corp., 9 Wash. App. 337, 339, 512 P.2d 751, 753 (1973) (franchisor told prospective franchisees not to take the written proposal to a lawyer because the franchisor would not agree to change one word).

5. *See infra* notes 21-23 and accompanying text.

6. *See infra* note 21.

other issues. Litigation includes safeguards such as prohibitions against hearsay evidence, appeals from decisions of trial judges, and the doctrine of stare decisis, which are absent in the arbitral process.

The Federal Arbitration Act[7] (the "Act") does not suggest that *all* arbitration agreements are valid irrespective of their purpose or effect. Rather, it appears to mandate, and surely permits, nonenforcement on "such grounds as exist at law or in equity for the revocation of any contract."[8] The Act specifically exempts from its operation employment contracts of workers engaged in foreign or interstate commerce.[9] In *Wilko v. Swan*,[10] the United States Supreme Court refused to compel arbitration of claims based on rights created by the Securities Act of 1933. This case grew out of: (1) an agreement between the brokerage firm and its customer to arbitrate all future controversies that might arise; and (2) the subsequent allegations by the customer that he was induced to buy certain stock by the false representations of the defendant-partners in the brokerage firm. Confronted with the conflicting policies of the Federal Arbitration Act and the Securities Act of 1933, a prompt and more economical solution of controversies by arbitration versus protection through litigation of statutorily-created rights, the Court elected to invalidate the future-disputes arbitration clause in order to provide the investor with greater "certainty of legally correct adjustment."[11] Likewise, in another instance of conflicting policies expressed in different federal statutes, the Court held that an arbitration agreement cannot defeat an employee's statutory right to litigate his claim under Title VII of the Civil Rights Act of 1964.[12] Where the issue to be resolved is closely related to the public interest that another statute seeks to protect, pro-enforcement has been subordinated to the specific federal policy established by the other federal statute.[13]

Other cases have resolved conflicts between the Federal Arbitra-

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7. 9 U.S.C. §§ 1-14 (1982).
8. *Id.* § 2.
9. *Id.* § 1.
10. 345 U.S. 427 (1953).
11. *Id.* at 438. Arbitration is inappropriate because the arbitrators are without instruction on the law and an award will be unaccompanied by the reasons therefor and not subject to judicial review. *Id.* at 435-36.
12. *See* Alexander v. Gardner-Denver Co., 415 U.S. 36 (1974).
13. *See supra* notes 10 & 12 and accompanying text; *see infra* notes 15 & 16 and accompanying text.

tion Act's pro-enforcement policy and other federal statutes creating rights which a claimant wished to litigate in favor of enforcement. The pro-enforcement policy will prevail unless the matter is too closely tied to the public interest to be left for substantive adjudication other than by the courts.[14]

Public policy arguments against the enforcement of arbitration clauses can be found in state, as well as federal, regulatory statutes. In *Merrill Lynch, Pierce, Fenner & Smith, Inc. v. Ware*,[15] Ware, a registered representative for Merrill Lynch, agreed that any controversy arising out of the termination of employment would be settled by arbitration. At termination, a dispute arose regarding Ware's right to compensation under the profit-sharing clause of the employment contract. Ware resisted his former employer's demand for arbitration on the ground that the California Labor Code gave him and other wage earners a right of action despite any agreement to arbitrate. The United States Supreme Court held that where California manifested a strong statutory policy of protecting its wage earners from what it regards as undesirable economic pressures affecting the employment relationship, then that policy should prevail absent any interference with the federal regulatory scheme.[16] Thus, in *Merrill Lynch*, the supremacy clause did not require federal preemption. Instead, the California regulatory statute was permitted to exclude arbitration as a method of resolving a claim arising from the state-created statutory right to litigate the claim in question.

In summary, courts have exempted certain matters which are deemed too closely tied to important public policies to be resolved outside the court system. The source of such overriding policy has been found on both the federal and state levels. For example, the arbitration clauses in *Wilko* and *Merrill Lynch* were not enforced in order to protect investors and employees, respectively. Since the franchisee is certainly an investor and arguably an employee, considering the many contractual restraints on him in the operation of "his" retail business, these examples indicate that the arbitration

14. *See, e.g.*, Fallick v. Kehr, 369 F.2d 899 (2d Cir. 1966) (holding that arbitration of a pre-bankruptcy debt was not precluded by the Bankruptcy Act); Moran v. Paine, Webber, Jackson & Curtis, 279 F. Supp. 573 (W.D. Pa. 1966) (invalidity of agreements for future arbitration of disputes in securities agreements does not apply to agreements to arbitrate an existing dispute).

15. 414 U.S. 117 (1973).

16. *Id.* at 139-40.

clauses in franchise agreements might also transgress public policy. Considering the judicial scrutiny given arbitration clauses in the past, one might reasonably have predicted that the significantly unequal bargaining power of franchisors and franchisees would free the latter from their promises to arbitrate future disputes. However, recent federal and state court decisions have held that the arbitral forum is appropriate for determining whether fraud initially induced the franchise agreement.[17]

II. The Franchise System

The franchise system is a significant part of the United States economy. Under this method of distributing goods and services, a franchisor contractually controls distribution by franchisees, privately-owned retail outlets, which benefit from the use of the franchisor's well-known trade or service mark. The presence and success of this system is obvious to all who observe national and regional advertising, and purchase goods and services from franchisees. The simpler forms of franchising are product and trade name franchising, under which automobile dealers, gasoline service stations, and soft drink bottlers merely acquire some of the identity of the trade name manufacturer, unaccompanied by the franchisor's promises to furnish management advice to the franchisee to help insure success of the business. Business format franchising goes beyond product and trade name franchising. Business format franchising is found, for example, in restaurants, nonfood retailing, real estate services, personal and business services, and rental services. In business format franchising, the franchisor furnishes not only the product or service and the trademark, but also furnishes the marketing strategy, operating manuals and standards, quality control, and continuing two-way communications.

The number of establishments operating under a business format franchise increased from 189,640 to 283,576 between the years 1972 and 1984, with an estimated 328,000 business format franchises in 1986.[18] The popularity of franchise operations is due to certain benefits unavailable in other, more traditional distribution systems. The franchisee's ownership of the retail business is

17. *See infra* notes 45-69 and accompanying text.

18. U.S. DEP'T OF COMMERCE, FRANCHISING IN THE ECONOMY 1984-86, 4 (1986). The sales of products and services by business format franchisors to their franchisees totaled $6.8 billion in 1984 and is predicted to rise to $8.4 billion in 1986. *Id.* at 5.

advantageous to the franchisor in that: (1) the products or services are distributed by a local person whose aggressive management is required to protect his investment and to succeed; and (2) the franchisor can rapidly expand its retail operations through franchisees who provide capital and assume the risk of business failure.

The basic benefit to the franchisee is his association with the franchisor's trade or service mark and its accompanying goodwill. But also very advantageous in business format franchise arrangements are the franchisor's promises to furnish expert management advice and other assistance that is unavailable to non-franchised retailers. These additional benefits include national or regional advertising by the franchisor, advice from the franchisor's experts, and information as to the best sources of equipment, supplies, and a site for the operation of the business.

III. Opportunity for Misrepresentation

Franchisors derive income from the franchisees' payments of fees and royalties, and in many instances from markups on the sale of equipment and supplies to franchisees. A franchisee's profits or losses will inevitably depend on what percentage of revenues are paid to the franchisor, as well as on his own skill and labor which are necessary to make the business succeed. Thus, the franchise agreement should be negotiated in an arms-length bargaining situation where each party aggressively pursues the terms most advantageous to him. In many instances, however, prospective franchisees lack both the skill and information required to exact the best possible terms from the franchisor. The franchisee's inadequacy in this regard often arises from his general lack of business experience. In addition, the prospective franchisee is often ignorant of the actual financial resources and policies of the franchisor, as well as the serious financial risks that he assumes by agreeing to operate a retail business. This informational imbalance works to the disadvantage of the franchisee in negotiating for terms critical to the success of his business.

The specific risks that a franchisee assumes depend upon the lengthy, written franchise agreement, which describes the complex rights and obligations of the parties. One term frequently included is that the parties will arbitrate, and not litigate, controversies arising from the franchise relationship. In addition, the writing may incorporate by reference ancillary agreements such as the lease of equipment or real estate and agreements in which the franchisor promises to provide training for the franchisee's personnel. At the time of negotiating the agreement, while contemplating the many practical problems of organizing and capitalizing the new business, the franchisee is likely to overlook the significance of his promise to submit to binding arbitration if a dispute arises in the future.

The Federal Trade Commission (FTC) has documented that misrepresentations and nondisclosures by franchisors inflict disastrous economic losses on franchisees.[19] The marketing of franchises has involved reprehensible franchisor conduct including: (1) misrepresentations of material facts about the nature and value of franchises; (2) unsubstantiated claims regarding sales and income of franchisees; and (3) failures to disclose material facts about franchise offerings.[20] These abuses demonstrate that fraud in the inducement is a valid concern for the courts. The history of the franchise industry demonstrates that a significant number of franchisees will need to rely on fraud in the inducement in seeking rescission of the franchise agreement or in defending against claims of the franchisor.

IV. Common Law and Statutory Redress

A. *Fraud and Deceit*

It is now well settled that the law will provide a remedy to a party injured by fraud or deceit occurring during the formation of a contract.[21] Fraud vitiates contracts, documents, and even judgments.[22] The rule is that an agreement induced by fraud is voidable, arming the defrauded party with the option of avoiding the agreement.[23] For a franchisee to prevail in a common law fraud action he must prove that: (1) the franchisor misrepresented a material fact; (2) the franchisor knew or should have known of the

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19. Statement of Basis and Purpose Relating to Disclosure Requirements and Prohibitions Concerning Franchising and Business Opportunity Ventures, 43 Fed. Reg. 59, 621-39 (1978). The public record contains over 400 complaints alleging abuses by over 170 franchisors. *Id.* at 59,627.

20. *Id.* at 59,628.

21. Prosser & Keeton on the Law of Torts § 105 (5th ed. 1984) (the writ of deceit was known in England as early as 1201, when it lay against a person who misused legal procedure for the purpose of swindling someone).

22. 37 Am. Jur. 2d *Fraud & Deceit* § 8 (1968 & Cum. Supp. 1986).

23. *Id.*

falsity of the statement, or that he made it without knowledge of its truth or falsity; (3) the franchisor intended to induce the franchisee to act upon the representation; and (4) the franchisee was injured due to his justifiable reliance upon the representation.[24] Considering the burden on a franchisee to prove each and every element, franchisors are adequately protected from frivolous claims of fraud by the franchisees.

The concept of fraud is complex. Only a judge who is familiar with the established body of law that sets the parameters of fraudulent conduct can identify that conduct intelligently where subtle distinctions are necessary. The expertise of judges is required not only by the complex nature of the fraud issue but also by the diversity of the evidence presented in fraud cases. In addition, uniform application of the law sanctioning fraud is desirable because it directly affects the stability of all contracts. Resolutions should not occur on an ad hoc basis as they do in arbitrations. Because arbitrators are often businesspersons and are not constrained by the precedents defining fraud in the inducement, they are more likely to ignore the objective standard expressed in the elements of fraud in favor of their own subjective notions of fairness. This can result in prejudice to either franchisor or franchisee in a particular arbitration. More importantly, arbitrators may fail to realize that the issue of fraud in the inducement is a threshold question, one which in litigation can result in judgment for the franchisee regardless of the merit of the franchisor's claims on non-fraud issues.

B. *Federal and State Administrative Regulation*

Under authority of the Federal Trade Commission Act,[25] the FTC has promulgated rules entitled Disclosure Requirements and Prohibitions Concerning Franchising and Business Opportunity Ventures,[26] which discourage certain franchisor practices. Known as rule 436, it is intended to eliminate deceptive and unfair busi-

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24. *E.g.*, Bisset v. Ply-Gem Indus., Inc., 533 F.2d 142, 146 (5th Cir. 1976) (affirming under Florida law a judgment for franchisees who were fraudulently induced into the franchise agreement by misrepresentations as to expert management assistance, profitability of other franchisees in the same system, availability of mass purchasing power, and a profitability survey of the franchisees' territory).

25. 15 U.S.C. §§ 41-58 (1982).

26. 43 Fed. Reg. 59,621-39 (1978) (a disclosure rule designed only to cure the informational imbalance existing between franchisors and franchisees during the sale of franchises, creating no private right of action in the franchisee for violations of the rule by the franchisor).

ness practices by requiring a franchisor to inform prospective franchisees about certain aspects of its operations. Under this rule, franchisors must provide potential investors with specific information prior to sale, such as information about the franchisor, the franchise business, and the terms of the franchise agreement.[27] Furthermore, if the franchisor makes claims regarding earning potential, it must provide additional information to support such claims.[28] Rule 436 does not appear to require the franchisor to explain to the prospective franchisee the important legal rights that will be waived by the arbitration clause, although section 436.1(a)(4)(ii) of the rule does appear to require the franchisor to disclose any arbitrations, as well as litigation, between it and franchisees during the seven years preceding the current negotiations.[29] Thus, while the FTC requires the franchisor to disclose that arbitrations have taken place, it does not appear to require a franchisor to explain the safeguards waived by the arbitration clause in the proposed arbitration agreement.

While rule 436 generally prohibits material misrepresentations and certain nondisclosures, and requires an extensive disclosure document (in the nature of a prospectus) with a minimum of twenty specified items of information, the power to enforce the rule lies exclusively with the FTC. Franchisees have no private cause of action, express or implied, under rule 436.[30] No matter how flagrantly a franchisor violates the FTC rule, an injured franchisee must resort to the court system for redress under traditional notions of contract law unless, of course, he has abandoned his right to litigate by agreeing to arbitrate.

State law may also provide statutory protection to the franchisee. The nature of this protection varies widely from state to state. Some statutes require full and accurate disclosure of information prior to execution of the franchise agreement.[31] Other stat-

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27. *Id.*

28. *Id.*

29. Final Guides to the Franchises and Business Opportunity Ventures Trade Regulation Rule, 44 Fed. Reg. 49,972, 49,973 (1979). Final Interpretive Guides do not appear to require a disclosure that an arbitration clause will deny the franchisee access to the courts for resolution of future disputes. *Id.* at 49,972-82.

30. Bus. Franchise Guide (CCH) ¶ 7,652 (citing Chelson v. Oregonian Publishing Co., 1 Trade Cas. (CCH) ¶ 64,031 (D. Or. 1981), *rev'd on other grounds*, 715 F.2d 1368 (9th Cir. 1983)).

31. *See* ARK. STAT. ANN. § 70-814 (1979); CAL. CORP. CODE §§ 31000-516 (West 1977 & Cum. Supp. 1986); FLA. STAT. ANN. § 817.416 (West 1983); HAW. REV. STAT. §§ 482E-1 to -12 (1985); ILL. ANN. STAT. ch. 121 ½, para. 701-40 (Smith-Hurd Cum. Supp.); IND. CODE ANN.

utes regulate the substantive contractual relationship after the franchise has been purchased.[32] Others afford additional protection by providing that: (1) the franchisor must register with the state before offering to sell franchises;[33] and (2) the franchisee shall have a right to sue based on the rights created by the statute.[34] California provides that, subject to federal limitations,[35] statutory rights conferred on the franchisee may be litigated by the franchisee despite an arbitration clause that would otherwise preclude litigation.[36]

C. *Recent Court Involvement in Franchise Relationships*

Court remedies for franchisees induced into an agreement by a franchisor's common-law fraud have already been noted. Courts also apply other legal principles in an innovative manner to balance the respective interests of parties to the franchise agreement. Developing case law of a few states provides that: (1) franchise termination is impermissible in the absence of good cause;[37] (2) franchise termination must be defended by the franchisor against the standard of good faith and fair dealing, due to the fiduciary

§§ 23-2-2.5-1 to -2.5-51 (Burns 1984 & Cum. Supp. 1986); MD. ANN. CODE art. 56, §§ 345-365D (1983); MICH. COMP. LAWS §§ 445.1501 to .1545 (Cum. Supp. 1986); MINN. STAT. §§ 80C.01-.22 (1982); N.Y. GEN. BUS. LAW §§ 680-95 (McKinney 1984); N.D. CENT. CODE §§ 51-19-01 to -19-17 (1982); OR. REV. STAT. §§ 650.005 to .085 (1983); R.I. GEN. LAWS §§ 19-28-1 to -28-15 (1982); S.D. CODIFIED LAWS ANN. §§ 37-5A-1 to -5A-87 (1977 & Supp. 1983); VA. CODE ANN. §§ 13.1-563 (Repl. Vol. 1985); WASH. REV. CODE ANN. §§ 19.100.010 to .100.940 (1978 & Cum. Supp. 1986); WIS. STAT. ANN. §§ 553.01-.78 (West 1986).

32. *See* ARK. STAT. ANN. §§ 70-807 to -818 (1979); CAL. BUS. & PROF. CODE §§ 20000-43 (West Supp. 1986); CONN. GEN. STAT. ANN. §§ 42-133e-133h (West Supp. 1986); DEL. CODE ANN. tit. 6, §§ 2551-56 (1975 & Supp. 1984); HAW. REV. STAT. § 482E-6 (1985); ILL. ANN. STAT. ch. 121 ½ para. 701-40 (Smith-Hurd Cum. Supp. 1986); IND. CODE ANN. § 23-2-2.7 (Burns 1984 & Cum. Supp. 1986); MICH. COMP. LAWS § 445.1527 (Supp. 1986); MINN. STAT. ANN. § 80C.14 (West 1986); MISS. CODE ANN. §§ 75-24-51 to 75-24-61 (Cum. Supp. 1986); MO. ANN. STAT. §§ 407.400 to .410, 407.420 (Vernon 1979 & Cum. Supp. 1986); NEB. REV. STAT. §§ 87-401 to -410 (1981); N.J. STAT. ANN. §§ 56:10-1 to -12 (West Supp. 1986); VA. CODE ANN. § 13.1-564 (Repl. Vol. 1985); WASH. REV. CODE ANN. §§ 19.100.180, 19.100.190 (1978 & Cum. Supp. 1987); WIS. STAT. ANN. §§ 135.01-.07 (1974 & Cum. Supp. 1986).

33. *See, e.g.*, VA. CODE ANN. § 13.1-560 to -562 (Repl. Vol. 1985).

34. *See, e.g.*, N.Y. GEN. BUS. LAW § 691 (McKinney 1984).

35. *See infra* notes 51-54 and accompanying text.

36. California Franchise Investment Law, CAL. CORP. CODE § 31512 (West 1977 & Supp. 1986); *see* Keating v. Superior Court, 31 Cal. 3d 584, 645 P.2d 1192, 183 Cal. Rptr. 360 (1982), *appeal dismissed in part, rev'd in part*, 104 S. Ct. 852 (1984) (interpreting § 31512 to mean that an arbitration clause did not preclude a franchisee from litigating provisions of the California Franchise Investment Law).

37. *See, e.g.*, Shell Oil Co. v. Marinello, 63 N.J. 402, 307 A.2d 598 (1973), *cert. denied*, 415 U.S. 920 (1974) (good cause required for franchisor to terminate franchise).

nature of the relationship;[38] and (3) terminations are subject to review under the unconscionability provisions of the Uniform Commercial Code.[39] These innovative approaches are in their incipiency. Their development cannot evolve through arbitrations since arbitration awards do not serve as precedents. That these important issues will be removed from court consideration by broadly worded arbitration clauses is all the more reason to provide litigation as a safety valve for the issue of fraud in the inducement.

Continued court involvement is necessary despite state and federal regulatory efforts to compensate for the imbalance between the respective informational, contractual, and economic positions of a franchisor and its franchisees. Because the federal and most state statutes do not give the franchisee a private right of action for violations of the disclosure statutes, such enactments only complement the common law by condemning misrepresentations and requiring appropriate disclosures. Creating no private cause of action, these statutes leave to the courts the job of applying other laws in deciding controversies between parties to a specific franchise agreement.

Because regulatory agencies are not empowered to resolve allegations of fraud in the inducement at the request of an injured party, the issue of fraud in the inducement must be resolved by litigation or arbitration in the absence of a compromise settlement between the parties. As between suits and arbitrations, it is suggested that the issue is appropriate for resolution only in the court system due to the limitations of the arbitration alternative.

In addition to limitations already mentioned, arbitrators are neither required nor expected to understand and apply complex legal principles. An arbitrator is often selected because of his particular commercial specialty. Undoubtedly, his concept of fraud will be influenced heavily by existing commercial practices, as well as by his own experiences and past commercial dealings. Judges, however, know that the role of the court is to determine whether or

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38. *See, e.g.*, Arnott v. American Oil Co., 609 F.2d 873 (8th Cir. 1979), *cert. denied*, 446 U.S. 918 (1980) (franchisor breached fiduciary duty by terminating franchise without good cause).

39. *See, e.g.*, Ashland Oil, Inc. v. Donahue, 159 W. Va. 463, 473-74, 223 S.E.2d 433, 440 (1976) (franchise was a contract for the sale of goods and termination provision was unconscionable); *cf.* Zapatha v. Dairy Mart, Inc., 381 Mass. 284, 291, 408 N.E.2d 1370, 1375 (1980) (doctrine of unconscionability applied although franchise agreement was not a contract for the sale of goods).

not business conduct is within legally acceptable norms. Judges are also aware that the franchisee must prevail when he can prove fraud in the inducement, regardless of the merits of other claims or cross-claims the franchisor may exert.

D. *Enforcement of Arbitration Agreements*

Commercial arbitration, by definition, is binding arbitration pursuant to a contract in which the parties have agreed to submit any controversy to arbitration and accept the ensuing award as the final resolution of their dispute. As mentioned previously, the primary benefits from arbitration, as compared to litigation, are speed and economy.

Speed and economy are possible in many instances for several reasons. The greatest catalyst for these attributes of arbitration is the expertise of particular arbitrators with regard to technical aspects of the specific controversy. For example, a construction engineer would make an ideal arbitrator for a dispute over building specifications and costs. His participation as arbitrator will save the parties time and money in both the preparation and the presentation of the case by eliminating the need to educate a judge and perhaps also a jury. Speed and cost containment are fostered also by the avoidance of crowded court dockets, lengthy pre-trial discovery, the strict rules of evidence observed at trial, and appeals from decisions of trial judges. Also, since arbitrators are not bound by the doctrine of stare decisis, the need for extensive legal research and briefs analyzing the applicable law is unnecessary.

The perceived benefits of arbitration, together with the recent quest of the legal community to find viable alternatives to litigation, have resulted in the modernization of the law of arbitration, including a policy of enforcing almost any agreement to arbitrate. The common-law rule that a promise to arbitrate was revocable at any time before rendition of the award has been abolished in almost all states by legislation[40] or judicial decision.[41] Moreover, the Federal Arbitration Act[42] preempts state arbitration laws whenever

40. M. DOMKE, COMMERCIAL ARBITRATION §§ 3:01-02, 4:01 (1984) (modern arbitration statutes are gradually supplanting the common law).

41. *See, e.g.*, Board of Educ. v. W. Harley Miller Inc., 160 W. Va. 473, 236 S.E.2d 439 (1977) *modifying* 159 W. Va. 120, 221 S.E.2d 882 (1975) (agreements to arbitrate future disputes enforceable even in the absence of a modern arbitration statute).

42. 9 U.S.C. §§ 1-14 (1982).

interstate commerce is involved,[43] nullifying the usual deference afforded state law under *Erie Railroad Co. v. Tompkins*.[44] Consequently, the Federal Arbitration Act is often the governing law.

E. *Federal Cases*

That fraud in the inducement of a contract is arbitrable under the Federal Arbitration Act became settled in *Prima Paint Corp. v. Flood & Conklin Manufacturing Co.*[45] The majority opinion in that case concluded that the Federal Arbitration Act is applicable in diversity cases when the contract involves interstate commerce.[46] Thus, *Prima Paint* provides that a broadly worded arbitration clause[47] denies both federal and state courts the jurisdiction to resolve the issue of fraud in the inducement whenever federal courts would have jurisdiction regardless of the basis of that jurisdiction.

The superficiality of the majority's rationale in *Prima Paint* is attacked in the dissenting opinion. Justice Black, summarizing the views of the dissenting Justices, noted:

> The Court holds, what to me is fantastic, that the legal issue of a contract's voidness because of fraud is to be decided by persons designated to arbitrate factual controversies arising out of a valid contract between the parties. And the arbitrators who the Court holds are to adjudicate the legal validity of the contract need not even be lawyers, and in all probability will be nonlawyers, wholly unqualified to decide legal issues, and even if qualified to apply the law, not bound to do so. I am by no means sure that thus forcing a person to forego his opportunity to try his legal issues in the courts where, unlike the situation in arbitration, he may have a jury trial and right

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43. *See* Southland Corp. v. Keating, 465 U.S. 1 (1984); Prima Paint Corp. v. Flood & Conklin Mfg. Co., 388 U.S. 395, 404-07 (1967); *see also* Robert Lawrence Co. v. Devonshire Fabrics, Inc., 271 F.2d 402, 404-05 (2d Cir. 1959) (holding that the Federal Arbitration Act created national substantive law clearly constitutional under the maritime and commerce powers of Congress).

44. 304 U.S. 64 (1938).

45. 388 U.S. 395 (1967) (holding that fraud in the inducement of the entire contract was properly an issue for arbitration notwithstanding language in the Act that an arbitration agreement shall be valid, irrevocable, and enforceable in the absence of legal or equitable grounds for revocation of any contract).

46. *Id.* at 401.

47. The clause reads: "Any controversy or claim arising out of or relating to this Agreement, or the breach thereof, shall be settled by arbitration in the City of New York, in accordance with the rules then obtaining of the American Arbitration Association. . . ." *Id.* at 398.

to appeal, is not a denial of due process of law.[48]

Prima Paint involved a consulting agreement entered by parties of relatively equal bargaining power. However, the dissent noted the undesirability of applying the majority's rule to the case where "a valid arbitration provision [is] contained in a contract between parties of unequal bargaining power."[49] The dissent particularly objected to "insurance, employment, construction, and shipping contracts as routinely containing arbitration clauses and being offered on a take-it-or-leave-it basis to captive customers or employees."[50] However, because franchising was not a significant method of distribution in 1967, it is not surprising that the dissent did not include franchise agreements in this list of suspect arbitration clauses. It appears that franchise agreements should be added to this list in view of the history of disappointed franchisees.

In *Southland Corp. v. Keating*,[51] the United States Supreme Court held that the provision of a California statute precluding enforcement of an agreement to arbitrate certain types of claims was preempted by the Federal Arbitration Act, under the supremacy clause of the United States Constitution.[52] Several suits, consolidated under the name *Southland Corp.*, were begun in California courts by franchisees who alleged fraud, misrepresentation, breach of contract, breach of fiduciary duty, and violation of the disclosure requirements of the California Franchise Investment Law.[53] The Supreme Court of California took the position that most of the franchisees' claims must be arbitrated under the broadly worded arbitration clause, but not those brought under the California Franchise Investment Law. However, the United States Supreme Court reversed, holding that California could not require judicial consideration of the statutory claims.[54]

Federal preemption is justified in the majority opinion on the basis of congressional intent and forum shopping. It is apparent from language appearing in both the majority[55] and dissenting[56]

48. *Id.* at 407 (Black, J., dissenting) (Douglas & Stewart, J.J., joined in Justice Black's dissenting opinion).
49. *Id.* at 414.
50. *Id.*
51. 465 U.S. 1 (1984).
52. *Id.* at 16.
53. CAL. CORP. CODE §§ 31000-31516 (West 1977).
54. *See supra* note 36 and accompanying text.
55. *Southland Corp.*, 465 U.S. at 12-16.
56. *Id.* at 25-29 (O'Connor, J., dissenting).

opinions that congressional intent on federal preemption is at best ambiguous. Determining the intent of the 68th Congress in 1925 is difficult because the Federal Arbitration Act was passed thirteen years before the *Erie* doctrine was established.[57] Prevention of forum shopping as a justification for the majority in *Southland Corp.* is not a valid basis for preemption, as pointed out by the dissent. As noted in Justice O'Connor's dissent, the Federal Arbitration Act was designed in 1925 to prevent forum shopping of a kind different from that feared by the Court's majority in 1984. Ironically, the Federal Arbitration Act was passed specifically to eliminate forum shopping that attempted to avoid arbitration under the pro-enforcement laws of a few major commercial states such as New York. Thus, the Act, borrowing heavily from the language of New York's innovative arbitration statute, eliminated the ability to avoid pro-enforcement policy when diversity provided jurisdiction to a federal court.[58]

The Court in 1984 feared the reverse—using state systems to avoid the federal, pro-enforcement policy—although Justice O'Connor points out that such a fear is unfounded. Since diversity jurisdiction allows either party access to the federal forum, no party can gain an advantage by forum shopping. Even when the party resisting arbitration initiates an action in the state system, the opposition can secure a federal court order compelling arbitration.[59] When diversity is incomplete, the federal system is not available to any party on the basis of diversity, so forum shopping is obviously not possible.

While both the majority and dissenting opinions in *Southland Corp.* are rhetorical, halting, and self-conscious, Justice Stevens' opinion, concurring in part and dissenting in part, identifies and addresses the states' interest in protecting franchisees.[60] Justice Stevens believed that a state should be permitted to regulate the relationship between a franchisor and its franchisees and preclude arbitration. He would respect the state policy because of "the rela-

57. *See* Prima Paint Corp. v. Flood & Conklin Mfg. Co., 388 U.S. 395, 405 n.13 (1967).

58. *See Southland Corp.*, 465 U.S. at 34-35 (O'Connor, J., dissenting).

59. Moses H. Cone Memorial Hosp. v. Mercury Constr. Corp., 460 U.S. 1 (1983) (holding that the policy of rapid and unobstructed enforcement of arbitration agreements precludes a federal court with diversity jurisdiction from yielding to parallel litigation in a state court since federal law governed issue of arbitrability in either state or federal court).

60. *Southland Corp.*, 465 U.S. at 20 (Stevens, J., concurring in part and dissenting in part).

tive disparity in the bargaining positions between the franchisor and the franchisee, and the remedial purposes of the California Act."[61] Thus, Justice Stevens prefers a rule allowing states to create statutory franchisee rights that cannot be arbitrated, and providing that the states' decision would be binding on both federal and state courts.

F. *State Cases*

State courts of Arizona, Minnesota, and Washington have addressed issues involving enforcement of arbitration clauses lodged in franchise agreements. In *Flower World of America, Inc. v. Wenzel*,[62] an Arizona court held that the broadly worded arbitration clause required the franchisee to arbitrate his claims arising under Arizona's Consumer Fraud Act. While the state statute authorized a private cause of action, the Arizona court characterized the franchisee's claim as:

> a private dispute arising out of a commercial transaction when the parties have agreed . . . to settle such disputes . . . [by arbitration]. Whatever the nature of the deceptions employed in the negotiations with [the franchisee], it cannot be said that the violations could affect hundreds of thousands—perhaps millions—of people and inflict staggering economic damage.[63]

It followed, the court reasoned, that arbitration was required. However, the court pointed out that arbitration by the parties would not prevent the Arizona Attorney General from enforcing the state's Consumer Fraud Act,[64] leaving the state statute with at least an air of respectability.

In *Pinkis v. Network Cinema Corp.*,[65] the franchisees alleged that numerous franchisor misrepresentations induced them to enter franchise relationships, as well as violations of the Washington Franchise Investment Protection Act. The franchisees' allegations revolved around the franchisor's promises to advise and train, and provide educational materials, promotional assistance, advertising, and bookings in connection with the operation of "Jerry

61. *Id.*
62. 122 Ariz. 319, 594 P.2d 1015 (Ct. App. 1978).
63. *Id.* at __, 594 P.2d at 1019.
64. *Id.* at __, 594 P.2d at 1020.
65. 9 Wash. App. 337, 512 P.2d 751 (1973).

Lewis Cinemas" franchises. The Washington court held that the broadly worded arbitration clause precluded litigation of all of the issues. Because the Federal Arbitration Act was applicable and *Prima Paint* mandated arbitration of the issue of fraud in the inducement, the court held that the franchisees' claims must be arbitrated.[66]

The Supreme Court of Washington later addressed the same issue in *Allison v. Medicab International, Inc.*,[67] holding that the broadly worded arbitration clause, interstate commerce involvement, the Federal Arbitration Act, *Prima Paint*, and the supremacy clause of the United States Constitution combined to preclude litigation of the fraud issue.[68] As in *Pinkis*, the franchisees sought to avoid arbitration by asserting rights under the Washington Franchise Investment Protection Act. However, the franchisor was able to enforce the arbitration clause in the franchise agreement since all of the requisites for federal preemption were satisfied. As the brief concurring opinion in *Allison* pointed out, "the holding effectively deprives a Washington resident of the protection and remedies provided by our Franchise Investment Protection Act."[69]

Atcas v. Credit Clearing Corp. of America[70] involved the typical business format franchise in which the franchisor represents that it will provide expert management guidance to the franchisee and also help train the franchisee's employees. The *Atcas* franchise was a credit card operation in which the franchisees were to procure a specified number of merchants who would pay membership fees in exchange for credit extended to the merchant's customers. The franchisees were to receive the major portion of the fees, but were required to pay the franchisors the sum of $33,750 upon signing the agreement. During the franchise negotiations, the franchisor made numerous oral and written representations concerning his role in insuring the success of the franchisees' business, including the statements that he would contact 10,000 merchants for possible leads and that the loss experience of member-merchants was less than two percent. Within sixteen months of signing the agreement, the franchisees filed suit alleging fraud in the inducement

66. *Id.* at ___, 512 P.2d at 757.
67. 92 Wash. 2d 199, 597 P.2d 380 (1979).
68. *Id.* at ___, 597 P.2d at 382-83.
69. *Id.* at ___, 597 P.2d at 383.
70. 292 Minn. 334, 197 N.W.2d 448 (1972).

and the resultant loss of their $36,291.95 investment.[71]

When the francisees sought rescission and accompanying restitution for the money paid to the franchisor, the latter demanded arbitration. The *Atcas* court held that the arbitration clause[72] in the franchise agreement was too narrow to encompass arbitration of claims of fraud in the inducement. While this was enough to allow the franchisees' suit to proceed, the court nevertheless went on to mention the dilemma presented by many cases of fraud in the inducement. The claim of fraud is often embraced within the claim of a substantive breach of contract. For example, if the franchisor promises to train the franchisee's personnel with no present intent to do so, the promise will constitute a fraudulent misrepresentation, as well as a simple breach of contract if the training is not provided. Thus, a party might delay arbitration of the breach of contract issue by asserting allegations of fraud in the inducement. Arbitrators are far more able to resolve issues of fact than issues of law. Even the arbitrator with no legal training can easily determine whether in fact the promised training was provided. Obviously, a delay in this determination defeats the major benefit of arbitration, a speedy final resolution of a legal dispute. The possibility of delay and greater litigation costs notwithstanding, the *Atcas* court distinguished fraud claims involving issues of law from breach of contract claims involving primarily issues of fact and held that a claim of fraud is more properly determined by those trained in the law than by arbitrators.[73]

Atcas appears as an aberration in the galaxy of cases in which franchisees have been compelled to arbitrate the fraud issue. Although the *Atcas* franchise involved interstate commerce, as well as complete diversity of citizenship between the parties, the franchisor failed to call into play either the federal forum or the Federal Arbitration Act. The state court avoided the holding in *Prima Paint* by finding that the language of the arbitration clause was too narrow to encompass fraud in the inducement. Moreover, *Southland Corp.* was then yet to be decided by the Supreme Court. While the views expressed in *Atcas* are still valid as to the

71. *Id.* at __, 197 N.W.2d at 450-51.
72. The clause read as follows: "This Agreement shall be governed by, and construed under the laws of Florida. Any controversy whatsoever, relating to this Agreement shall be settled by arbitration . . . under the laws of the American Arbitration Association, before any action or proceeding can be brought or maintined." *Id.* at __, 197 N.W.2d at 451.
73. *Id.* at __, 197 N.W.2d at 457.

differing qualifications of judges as compared to those of arbitrators, surely a modern franchisor would take advantage of *Southland Corp.* to insure that the issue of fraud in the inducement was resolved by arbitration.

V. CONCLUSION

Since a franchisor normally extends his operations over a region of several states, or nationally, a legal controversy between it and one of its franchisees will normally involve interstate commerce. If the parties to the controversy represent a complete diversity of citizenship, and the transaction involves interstate commerce, the Federal Arbitration Act will apply to require arbitration under a broadly worded arbitration clause. While the policy of enforcing arbitration clauses may operate fairly in many areas of commercial activity, the history of the franchise industry, including court cases in which franchisees have attempted to avoid arbitration, demonstrates that franchisees often have opposed arbitration as a means of resolving the fraud issue.

Because research has not uncovered a case in which a franchisee sought enforcement of an arbitration clause, one may conclude that such clauses are more favored by franchisors than franchisees. It follows that abandonment of the doctrine of stare decisis and other restrictions and safeguards imposed in litigation in favor of the speed and cost containment of arbitration is more popular and advantageous to franchisors than it is to franchisees. If arbitration is not inherently more advantageous to franchisors, franchisees are less informed as to its benefits when a dispute arises.

The written arbitration agreement is usually prepared by the franchisor. Although FTC rule 436 requires the franchisor to furnish the prospective franchisee with the basic disclosure document at least ten days before he signs the franchise agreement, and give the franchisee a copy of the written franchise agreement at least five days before its execution, these documents are inadequate to advise the prospective franchisee of the potentially adverse impact of the arbitration clause. Theoretically, the franchisee might seek legal advice regarding the terms set out in the document during the five-day period, and as a result request elimination of the arbitration clause. However, there is little incentive for the franchisor to yield to this request. At that time, the arbitration clause appears far less important to the franchisee than the practicalities associated with the commencement of a new business, and may also appear unimportant in light of his expectation of a successful retail establishment.

While one can argue that the franchisee should retain access to the court system by insisting on the elimination of the arbitration clause, it is unlikely that he would allow the disagreement over this one term to prevent consummation of the agreement. It is even more unlikely that he would insist on modification of the arbitration clause to exclude arbitration of the issue of fraud in the inducement. Although such a demand might be tactically wise, it would be tantamount to an accusation of deceit—hardly a good beginning in establishing a working relationship with the franchisor. A theoretical alternative to exempting fraud claims from arbitration is for the franchisee to conduct an expensive and time consuming investigation of the franchisor to determine the validity of the franchisor's representations, if he has the means to do so. Although the Federal Trade Commission rule attempts to eliminate misrepresentations and insure appropriate disclosures, it leaves the franchisee without a private right of action against a franchisor who violates the rule.

Although the ultimate form of remedial legislation cannot be predicted, it is nevertheless fitting to suggest what form a statute designed to insure litigation of the fraud issue when appropriate should take. One obvious solution is to amend the Federal Arbitration Act and similar state laws to provide that the issue of fraud in the inducement be reserved for court determination. The Act already exempts from its coverage employment contracts of workers engaged in interstate commerce.[74] This absolute prohibition would insure that the allegations of fraud were resolved under the doctrine of stare decisis in all instances. If, from the court hearing, it appears that the franchisee alleged fraud when realistically he had no more than an ordinary breach of contract claim, then the remedial statute would empower the judge to transfer the franchisor's litigation costs, including attorney's fees, to the franchisee. If the allegations of fraud are proved, and absent an appeal by the franchisor, the litigation cost savings to both parties would be significant because the franchise agreement would then be declared void. However, there appears to be no move in this direction. Proponents of such a move, if they exist, are difficult to identify be-

74. 9 U.S.C. § 1 (1982).

cause franchisees are not ultimate consumers who are championed by consumer advocates and the news media. Nor are they a well organized group with representatives who are in a position to obtain legislation insuring that judges, and not arbitrators, resolve allegations of fraud in the inducement.

As an alternative to an absolute prohibition against arbitration of the issue of fraud in the inducement, Congress and state legislatures should amend existing laws to permit arbitration of the fraud issue only upon proof of an intelligent waiver by the franchisee of his right to litigate. Such remedial statutes must provide that, for the waiver to be effective, the franchisor must furnish the prospective franchisee with a written statement of the effect of the arbitration clause. The contents of the statement are suggested in the final paragraph of this article. In addition, the arbitration clause in the written franchise agreement must be signed separately by the franchisee. If the franchisee genuinely assents to the arbitration of future disputes, then he should not be heard to complain about being foreclosed from litigation.

Disclosure statutes, even those giving no private right of action to the franchisee, do afford some protection by attempting to correct the informational imbalance between the franchisor and a prospective franchisee. Rule 436, the federal disclosure vehicle, is especially important in this regard because it is applicable throughout the United States. Considering the holding in *Southland Corp.*, rule 436 appears to be the only vehicle which protects franchisees from fraudulently induced franchise agreements. Since the rule does not currently require a disclosure of the effect of arbitration clauses on the franchisee, it should be amended. The amendment should require an adequate disclosure in both the basic disclosure statement and also in the written franchise agreement furnished by the franchisor. The disclosure should read as follows:

> Arbitration of any claim or controversy means that the claim or controversy including a claim of fraud in the inducement of this Agreement, will be resolved outside of the court system. Arbitrators are authorized under this clause to decide issues of both fact and law, and the parties agree that the arbitrator's decision shall be final, eliminating consideration thereof by the courts. The parties enter into this Agreement to arbitrate knowing that they give up certain safeguards inherent in litigation, including a jury trial, adherence to strict rules of evidence, and the right to appeal the decision of the

arbitrator. The parties to this Agreement understand also that arbitrators are not required to apply the law to the same extent and in the manner as it would be applied by a judge.