

# IS THERE A FLIGHT FROM ARBITRATION?

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## I. INTRODUCTION

Are parties fleeing arbitration? “Ten to [twenty] years ago,” one commentator writes, “arbitration was the proverbial fair-haired kid. It was touted as being cheaper, faster, and less confrontational than litigation.”<sup>1</sup> Today, the child seems to have grown into a troubled teenager. Reports of dissatisfaction with arbitration—not only by consumers and employees (and their advocates),<sup>2</sup> but also by businesses and their attorneys—appear with increasing frequency. One recent article in the legal trade press asserts that “arbitration may be losing some of its luster. Some attorneys complain that its costs and complexity have been rising, while losing parties express dissatisfaction at the difficulty of appealing in court what they regard as unfair verdicts.”<sup>3</sup> Another article states more confidently that “arbitration has fallen out of

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1. Rupert M. Barkoff, *Is the Bloom Off the Rose of Alternative Dispute Resolution?*, FRANCHISE UPDATE (Dec. 4, 2007), available at <http://www.franchise-update.com/articles/335> [hereinafter Barkoff, *Bloom*]; see also Rupert M. Barkoff, *Arbitration: No Longer the Fair-Haired Child*, L.J.N.’S FRANCHISING & BUS. L. ALERT (May 2008), at 5 [hereinafter Barkoff, *Fair-Haired Child*].

2. E.g., PUBLIC CITIZEN, *THE ARBITRATION TRAP: HOW CREDIT CARD COMPANIES ENSNARE CONSUMERS* (2007), available at [http://www.citizen.org/documents/Final\\_wcover.pdf](http://www.citizen.org/documents/Final_wcover.pdf); David S. Schwartz, *Enforcing Small Print to Protect Big Business: Employee and Consumer Rights Claims in an Age of Compelled Arbitration*, 1997 WIS. L. REV. 33; Jean R. Sternlight, *Creeping Mandatory Arbitration: Is It Just?*, 57 STAN. L. REV. 1631 (2005); Jean R. Sternlight, *Panacea or Corporate Tool? Debunking the Supreme Court’s Preference for Binding Arbitration*, 74 WASH. U. L.Q. 637 (1996) [hereinafter Sternlight, *Panacea*].

3. Beth Bar, *Some Attorneys Questioning Advantages of Arbitration*, N.Y. L.J., May 17, 2007, at 5. *But see id.* (“[B]usinesses that have generally found arbitration to be useful have not changed their views on it.”).

favor,”<sup>4</sup> while a recent article by a pair of prominent legal academics suggests that there is a “flight from arbitration.”<sup>5</sup>

Nowhere has the apparent change of heart toward arbitration been more visible than in franchising.<sup>6</sup> An article in the *National Law Journal* reports “increased franchisor disenchantment with arbitration,” with some attorneys suggesting that “the tide is turning against the alternative forum.”<sup>7</sup> Rupert Barkoff, a franchising lawyer, reports that “the franchise bar is starting to throw stones at arbitration.”<sup>8</sup> He finds a “growing skepticism toward arbitration. . . . Perhaps privacy is achieved,

4. Lou Whiteman, *Arbitration’s Fall from Grace*, IN-HOUSE COUNSEL, July 13, 2006, <http://law.com/jsp/ihc/PubArticleIHC.jsp?id=1152695125655>.

5. Theodore Eisenberg & Geoffrey P. Miller, *The Flight from Arbitration: An Empirical Study of Ex Ante Arbitration Clauses in the Contracts of Publicly Held Companies*, 56 DEPAUL L. REV. 335, 335 (2006).

6. Franchising is defined as follows:

Franchising is a form of business organization that economizes on monitoring costs in an enterprise with geographically dispersed outlets. The franchisor permits the franchisee to use its trademark and business model and provides training and guidance in running the business. In exchange, the franchisee pays the franchisor ongoing royalties and is responsible for various upfront costs.

Christopher R. Drahozal & Keith N. Hylton, *The Economics of Litigation and Arbitration: An Application to Franchise Contracts*, 32 J. LEGAL STUD. 549, 555-56 (2003). Prominent examples of franchises include 7-Eleven Inc. (convenience stores), Subway (sandwich shops), McDonald’s (fast-food restaurants), the UPS Store (shipping and office services), and Jiffy Lube International, Inc. (oil change services). See Entrepreneur.com, 2008 Franchise 500 Rankings, <http://www.entrepreneur.com/franchises/rankings/franchise500-115608/2008,-1.html> (last visited Feb. 2, 2009).

7. Lynne Marek, *As Franchises Take Off, So Do Lawsuits*, NAT’L L.J., Aug. 13, 2007, at 8; see also Richard Gibson, *On Franchising: Pressure Grows to Rethink the Use of Mandatory Arbitration Clauses*, WALL ST. J., June 3, 2008, at B7 (“But these days there is growing pressure—from franchisees, judges, Congress and even some franchisors—to rethink that longstanding arrangement [of using pre-dispute arbitration clauses in franchise agreements].”).

8. Marek, *supra* note 7 (quoting Rupert Barkoff); see also Hilary Buttrick et al., *Hot Topics in Mediation and ADR 17* (May 7-9, 2006) (unpublished paper, prepared for the International Franchise Association’s 39th Annual Legal Symposium, on file with the Hofstra Law Review) (“[M]any commentators are reconsidering these notions and carefully evaluating whether arbitration truly is a better alternative to litigation.”). For reports from other industries, see Steve A. Arbittier, *Conditional Arbitration: A New Approach to Construction Arbitration*, DISP. RESOL. J., May-July 2006, at 40 (“[T]he pendulum is swinging in the other direction. Arbitration has taken on many of the characteristics of ‘scorched earth’ litigation, with abusive discovery and never-ending motion practice. The increased dissatisfaction with arbitration has led the American Institute of Architects (AIA) to eliminate arbitration as the default dispute resolution process in its standard form agreements. Now drafters will have a menu of options from which to choose.”); and Julie Kay, *Employers Start to Push Waivers*, NAT’L L.J., June 9, 2008 (“[I]n the past couple of years, employment defense lawyers say some of their clients have grown disenchanted with arbitration and now prefer either bench trials before a judge or mediation.”); and Michael McIlwrath & Roland Schroeder, *The View from an International Arbitration Customer: In Dire Need of Early Resolution*, 74 ARB. 3, 10 (2008) (“We know from our interactions with in-house counsel at other companies that many have developed, or are developing, a real reluctance to resolve disputes through international arbitration where it can be avoided.”).

but speed, cost reduction, and finality have more and more often come into question.”<sup>9</sup> As a consequence of this dissatisfaction, “[a]necdotal evidence suggests that franchisors are either abandoning arbitration altogether or using more ‘carve-out’ provisions (exempting specific categories of disputes from the franchise agreement arbitration clause).”<sup>10</sup>

These reports—of dissatisfaction with the arbitration process leading to a “flight from arbitration”—are not based on any systematic study of changes in the use of arbitration clauses over time. Instead, the evidence of flight consists largely of anecdotes, together with a study showing a low usage of arbitration clauses in certain types of contracts.<sup>11</sup> But anecdotes should not be confused with empiricism, and static examinations of the use of arbitration clauses do not show “flight”—that is, that parties who previously agreed to arbitration are now switching to litigation.<sup>12</sup>

Whether parties are fleeing arbitration for litigation is important for a variety of reasons. Changes in party preferences for litigation versus arbitration provide insight into how parties perceive the comparative benefits (and costs) of those means of dispute resolution, and in particular whether that perception has changed in recent years. Changes in the terms of arbitration clauses as an alternative to flight provide information on how parties trade off the cost of the arbitration process against concerns about limited review of awards. They also offer a look at how businesses that operate on a nationwide basis respond to court decisions in states in which they do business—court decisions that seem

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9. Barkoff, *Fair-Haired Child*, *supra* note 1, at 5; *see also* Barkoff, *Bloom*, *supra* note 1 (“[T]he jury is still out, but I think the tide has turned – or at least become skeptical – about the liturgy of benefits deriving from arbitration.”).

10. Edward Wood Dunham & Michael J. Lockerby, *Shall We Arbitrate? The Pros and Cons of Arbitrating Franchise Disputes* 3 (Oct. 19-21, 2005) (unpublished paper, prepared for the ABA 28th Annual Forum on Franchising, on file with the Hofstra Law Review).

11. Eisenberg & Miller, *supra* note 5, at 350 (“Whatever arbitration’s supposed efficiencies, sophisticated actors are not flocking to it in a broad range of important contracts.”).

12. In previous work, Eisenberg & Miller used the word “flight” to refer to parties who agreed to the law of a state other than their state of incorporation to govern their contract. *See* Theodore Eisenberg & Geoffrey Miller, *Ex Ante Choices of Law and Forum: An Empirical Analysis of Corporate Merger Agreements*, 59 VAND. L. REV. 1975, 2007 (2006) (“[W]e define a choice of forum ‘flight’ variable analogous to the choice of law flight variable. ‘Choice of forum other than state of incorporation,’ (the choice of forum flight variable) equals one when the acquiring firm’s state of incorporation and choice of litigation forum do not match. It equals zero when they do match.”). Given that the default rule for dispute resolution is litigation, the mere fact that parties do not contract out of the default rule (by agreeing to arbitrate) cannot fairly be called a “flight” from arbitration. Instead, in our view, “flight” requires the parties to switch from arbitration to another form of dispute resolution. The switch can occur either when contracts are up for renewal or for wholly new contracts. But, at a minimum, “flight” requires some change in the use of arbitration clauses over time.

to reflect an increasing willingness to invalidate arbitration clauses (or at least various provisions in arbitration clauses).

This Article seeks to fill this gap in the literature. It examines systematically whether the use of arbitration clauses has changed over time—in other words, whether there has in fact been a flight from arbitration. It compares the use of arbitration clauses in franchise agreements from identical franchisors in 1999 and 2007 to see how, if at all, the clauses have changed.<sup>13</sup> Given the disenchantment with arbitration reportedly expressed by franchisors (who draft the standard form franchise agreements entered into by franchisees<sup>14</sup>), and the importance of franchised businesses in the United States economy,<sup>15</sup> franchising is an apt setting in which to test for a flight from arbitration.<sup>16</sup>

In this Article, we consider three related questions: (1) Have franchisors fled arbitration—that is, have franchisors replaced arbitration clauses in franchise agreements with other dispute resolution clauses? (2) Have franchisees fled arbitration, resulting in an increased market share for franchisors that do not include arbitration clauses in their franchise agreements relative to those that do? (3) As an alternative to flight, have franchisors modified their arbitration clauses in ways that respond to the reported reasons for dissatisfaction with arbitration?

We find that, in the aggregate, there has been little change in the use of arbitration clauses in the franchise agreements studied. The proportion of franchise agreements with arbitration clauses is essentially the same in 2007 (43.7%) as it was in 1999 (45.1%).<sup>17</sup> Viewed

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13. The results from 1999 were published in Christopher R. Drahozal, “Unfair” Arbitration Clauses, 2001 U. ILL. L. REV. 695.

14. Indeed, the proposed Arbitration Fairness Act of 2007 groups franchisees together with consumers and employees as parties needing protection from arbitration, and would make pre-dispute arbitration clauses unenforceable in franchise (as well as consumer and employment) contracts. See H.R. 3010, 110th Cong. § 4(4) (2007); S. 1782, 110th Cong. § 4(4) (2007).

15. According to a study prepared for the International Franchise Association, franchised businesses in 2005 provided over eleven million jobs (or 8.1% of the United States private sector workforce) and were responsible (directly or indirectly) for \$2.3 trillion in United States economic output. 2 NAT’L ECON. CONSULTING, THE ECONOMIC IMPACT OF FRANCHISED BUSINESSES 6-7 (2008).

16. Given that the reasons parties choose arbitration or litigation vary across industries and across contract types, it is difficult to draw general conclusions about a flight from arbitration based on a sample of franchise agreements. That said, our findings are consistent with the findings in a recent study on the use of arbitration clauses in executive employment contracts. See Randall Thomas et al., *When Do CEOs Bargain for Arbitration?: A Theoretical and Empirical Analysis* 21 (Vanderbilt Law & Econ. Research, Working Paper No. 08-23, 2008), available at <http://ssrn.com/abstract=1247843> (finding “an upward trend in the use of arbitration over time from a low of 35.9% of contracts in 1997 to 60.4% of contracts in 2005”).

17. See *infra* tbl.4.

individually, there has been some reshuffling among franchisors as to their chosen means of dispute resolution. Four franchisors (out of thirty-two, or 12.5%) replaced arbitration clauses in their franchise agreements with exclusive forum selection clauses, which was largely offset by three franchisors adding arbitration clauses to their franchise agreements (which previously had contained no dispute resolution clause at all).<sup>18</sup> This reshuffling of franchisors may provide at least a partial explanation for the anecdotal reports of flight. Because we do not have data on precisely when the franchisors switched the provisions in their franchise agreements, it is possible that the switches away from arbitration are more recent than the switches to arbitration, which might reflect a flight from arbitration. Of course, the converse could be true as well—that the switches to arbitration are more recent than the switches away from arbitration.

We also find little indication that franchisees are fleeing arbitration by avoiding franchisors that include arbitration clauses in their arbitration agreements. The number of franchised locations for franchisors in the sample that use arbitration clauses increased from 57,401 in 2000 to 76,166 in 2006.<sup>19</sup> The share of those franchised locations as a percentage of the total likewise increased, from 43.3% in 2000 to 46.0% in 2006.<sup>20</sup> These numbers provide no evidence that franchisees avoid franchisors that use arbitration.

Finally, most changes to the terms of arbitration clauses studied were relatively minor, although some are worth noting. The use of class arbitration waivers increased substantially (from approximately 50% to almost 80% of the clauses).<sup>21</sup> Notably, three (of twenty-eight, or 10.7%) of those class arbitration waivers included “non-severability” provisions under which,<sup>22</sup> if a court holds the class arbitration waiver invalid, the entire arbitration clause is invalidated. Given that a number of jurisdictions have held class arbitration waivers to be unconscionable or otherwise unenforceable,<sup>23</sup> these non-severability provisions result in what might be characterized as a partial but small flight from arbitration. The use of common carve-outs (that is, exceptions to arbitration) also increased slightly, again indicating a partial flight from arbitration, albeit

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18. See *infra* tbl.5.

19. See *infra* tbl.6.

20. See *infra* tbl.6.

21. See *infra* tbl.11.

22. See *infra* tbl.11.

23. See *infra* note 69.

only for those types of disputes or remedies excluded from the obligation to arbitrate.<sup>24</sup>

Meanwhile, few provisions seem to have been modified in response to the risk of court invalidation on unconscionability grounds (the non-severability provision being a leading exception). Instead, other common changes made to arbitration clauses appear to be ones designed to hold down the cost of the process, such as providing for a sole arbitrator instead of a panel of three arbitrators. Indeed, when franchisors faced a choice between provisions that would reduce cost and provisions that would reduce the risk of aberrational awards, the changes franchisors made were consistently those that would reduce cost.

Part II of the paper examines why parties agree to arbitrate. Part III discusses possible reasons why parties might flee arbitration. Part IV presents our empirical results, examining changes both in the use of arbitration clauses and in the terms of those clauses over time.

## II. WHY ARBITRATE?

The default rule governing the resolution of disputes is litigation. If the contract is silent on how disputes are to be resolved, the parties may go to court.<sup>25</sup> As the Supreme Court has repeatedly stated, parties can only be compelled to arbitrate if they have agreed to do so<sup>26</sup>—that is, if they have contracted around the default rule by entering into an arbitration agreement.

There is no single reason why parties include pre-dispute arbitration clauses in their contracts. The reasons vary depending on the type of contract involved and the sorts of claims that may arise.<sup>27</sup> Arbitration may make sense for one type of contract but not for another, and for one type of claim but not for another. Thus, it should not be surprising that

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24. See *infra* tbl.16.

25. Matthew T. Bodie, *Questions About the Efficiency of Employment Arbitration Agreements*, 39 GA. L. REV. 1, 9 (2004) (“In our system of dispute resolution, litigation is the ‘default rule’—the result that will take place unless the parties agree to a different alternative.”); see also Stephen J. Ware, *Employment Arbitration and Voluntary Consent*, 25 HOFSTRA L. REV. 83, 135 n.270 (1996) (referring to “the default rule that disputes are resolved by litigation, not arbitration”).

26. *First Options of Chicago, Inc. v. Kaplan*, 514 U.S. 938, 943 (1995); *AT&T Tech., Inc. v. Comm’n Workers of Am.*, 475 U.S. 643, 648-49 (1986).

27. E.g., Dunham & Lockerby, *supra* note 10, at 38 (“[T]he answer to the question ‘shall we arbitrate franchise disputes?’ is not self-evident. Even after undertaking the comparative analysis suggested in this paper, prudent franchisors, franchisees and franchise lawyers will still reach different conclusions about the wisdom of arbitrating.”).

the use of arbitration varies across industries and across firms, as well as within firms and even within contracts.<sup>28</sup>

Among the reasons parties may agree to arbitration (or may include arbitration clauses in their standard form contracts)<sup>29</sup> are the following:<sup>30</sup> (1) arbitration may resolve disputes more quickly and at lower cost than litigation;<sup>31</sup> (2) arbitration may reduce the risk of aberrational jury verdicts or punitive damages awards;<sup>32</sup> (3) arbitration may reduce a company's exposure to class actions or other forms of aggregate

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28. Studies of the use of arbitration clauses can be grouped into at least four categories: (1) inter-industry studies, which compare the use of arbitration clauses across industries, *see, e.g.*, Linda J. Demaine & Deborah R. Hensler, "Volunteering" to Arbitrate Through Predispute Arbitration Clauses: The Average Consumer's Experience, 67 LAW & CONTEMP. PROBS. 55, 62-64 (2004); Eisenberg & Miller, *supra* note 5, at 343; (2) inter-firm studies, which compare the use of clauses across firms within the same industry, *see, e.g.*, Drahozal & Hylton, *supra* note 6, at 558-60 (franchising industry); (3) intra-firm studies, which compare the use of arbitration clauses within a single firm, *see, e.g.*, Theodore Eisenberg et al., *Arbitration's Summer Soldiers: An Empirical Study of Arbitration Clauses in Consumer and Nonconsumer Contracts*, 41 U. MICH. J.L. REFORM 871, 878 (2008); and (4) intra-contract studies, which examine exceptions to arbitration within a single arbitration clause, *see, e.g.*, Drahozal, *supra* note 13, at 739-40.

29. Note that our focus here is on why parties agree to arbitrate (that is, the positive aspect of the decision) rather than on the extent to which these reasons benefit consumers, employees, or franchisees (that is, the normative aspect of the decision).

30. The discussion that follows focuses principally on domestic arbitration in the United States. For empirical evidence on the reasons parties include arbitration clauses in their international contracts, *see* CHRISTIAN BÜHRING-UHLE ET AL., ARBITRATION AND MEDIATION IN INTERNATIONAL BUSINESS 105-128 (2d ed. 2006).

31. Christopher R. Drahozal, *Arbitration Costs and Forum Accessibility: Empirical Evidence*, 41 U. MICH. J.L. REFORM 813, 826, 840 (2008).

32. Christopher R. Drahozal, *A Behavioral Analysis of Private Judging*, 67 LAW & CONTEMP. PROBS. 105, 131 (2004); Drahozal & Hylton, *supra* note 6, at 574. These concerns are illustrated by provisions in the Baskin-Robbins and Dunkin' Donuts franchise agreements that permit the franchisee to opt out of arbitration so long as it agrees to waive the right to jury trial and any claim for punitive damages. The provision reads as follows:

11.6 FRANCHISEE'S EXCEPTIONS. FRANCHISEE shall have the option to litigate any cause of action otherwise eligible for arbitration hereunder and shall exercise said option solely by filing a complaint in any court of competent jurisdiction in which FRANCHISEE expressly waives the right to a trial by jury and any and all claim(s) for punitive, multiple and/or exemplary damages. If any such complaint fails to include such express waivers or if any such court of competent jurisdiction determines that all or any part of such waivers shall be ineffective or void for any reason whatsoever, then the parties agree that the action shall thereupon be dismissed without prejudice, leaving the parties to their arbitration remedies, if then available pursuant to this Section 11.

Baskin-Robbins Franchising LLC, Franchise Agreement ¶ 11.6, at 17 (2007) (on file with the Hofstra Law Review). The provision in the Dunkin' Donuts franchise agreement is essentially identical to the one in the Baskin Robbins Franchise Agreement. *See* Dunkin Donuts Inc., Franchise Agreement ¶ 11.6, at 17 (2007) (on file with the Hofstra Law Review). Dunkin' Donuts and Baskin-Robbins are divisions of Dunkin' Brands, Inc., a private company. *See* Dunkin' Brands Corporate Press Kit, [http://www.dunkinbrands.com/pressroom/DBI\\_Press\\_Kit.pdf](http://www.dunkinbrands.com/pressroom/DBI_Press_Kit.pdf) (last visited Jan. 9, 2009).

litigation;<sup>33</sup> (4) arbitration may result in better outcomes because the decisionmakers are experts whose incentives differ from those of judges;<sup>34</sup> (5) arbitration may reduce the risk of disclosure of confidential information;<sup>35</sup> (6) arbitration may facilitate the use of privately developed trade rules;<sup>36</sup> (7) arbitration may better preserve the parties' relationship,<sup>37</sup> and other reasons as well.<sup>38</sup>

Conversely, the arbitration literature has identified at least two circumstances in which arbitration does not work well.<sup>39</sup> First, arbitration does not work well in cases requiring urgent action. Before the arbitrators can rule on a request for emergency relief, they must be appointed by the parties, which necessarily delays any ruling. Arbitration providers, such as the American Arbitration Association ("AAA"), have responded to this difficulty by establishing readily available panels to rule on emergency requests,<sup>40</sup> but that option appears to be used only rarely.<sup>41</sup> Thus, when parties anticipate that they may

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33. Eisenberg et al., *supra* note 28, at 888; Dunham & Lockerby, *supra* note 10, at 30 ("For franchisors, one of arbitration's greatest *potential* advantages over litigation is the ability to avoid class and consolidated actions in distant, hostile forums, by requiring individual franchisees to prosecute their individual claims in separate arbitrations, at a location designated in the franchise agreement.").

34. Drahozal & Hylton, *supra* note 6, at 558-60.

35. Amy J. Schmitz, *Untangling the Privacy Paradox in Arbitration*, 54 U. KAN. L. REV. 1211, 1222-26 (2006).

36. Lisa Bernstein, *Merchant Law in a Merchant Court: Rethinking the Code's Search for Immanent Business Norms*, 144 U. PA. L. REV. 1765, 1782-87 (1996).

37. See DAVID B. LIPSKY & RONALD L. SEEGER, THE APPROPRIATE RESOLUTION OF CORPORATE DISPUTES: A REPORT ON THE GROWING USE OF ADR BY U.S. CORPORATIONS 17 (1998), available at <http://digitalcommons.ilr.cornell.edu/icrpubs/4>.

38. See, e.g., *id.* at 17, 26 (reporting survey results).

39. These two circumstances, of course, are not the only reasons parties might choose litigation rather than arbitration. Another is when parties perceive the legal framework to be clear and the availability of a remedy relatively certain in court, as in the case of commercial loans. Keith N. Hylton, *Agreements to Waive or to Arbitrate Legal Claims: An Economic Analysis*, 8 SUP. CT. ECON. REV. 209, 231 (2000) ("Most loan contracts are relatively clear, and courts have a great deal of experience with them. An arbitration regime would risk diluting this predictability . . ."); William W. Park, *Arbitration in Banking and Finance*, 17 ANN. REV. BANKING L. 213, 215-16 (1998) ("[B]ankers have traditionally preferred judges over arbitrators. . . [because a] debtor's default usually results from simple inability or unwillingness to pay, rather than any honest divergence in the interpretation of complex or ambiguous contract terms.").

40. E.g., American Arbitration Association, *Optional Rules for Emergency Measures of Protection*, Rules O-1 to O-8 (amended and effective Sept. 1, 2007), available at <http://www.adr.org/sp.asp?id=22440> (last visited Jan. 20, 2009).

41. Buttrick, *supra* note 8, at 19 ("Despite the availability of these injunctive procedures in arbitration, many parties still prefer the relative reliability and predictability of the courts when it comes to obtaining a temporary restraining order or a preliminary injunction."); Christopher R. Drahozal, *Party Autonomy and Interim Measures in International Commercial Arbitration*, in INTERNATIONAL COMMERCIAL ARBITRATION: IMPORTANT CONTEMPORARY QUESTIONS 179, 183 (Albert Jan van den Berg ed., 2003) ("The Rules apply, however, only when agreed to by the parties 'by special agreement or in their arbitration clause,' and such agreements were rare in the sample



need to seek emergency relief in the event of a dispute, one would expect them to exclude such requests from arbitration or perhaps avoid arbitration altogether.<sup>42</sup>

Second, parties may avoid arbitration of what might be called “bet-the-company” cases—high stakes cases in which an erroneous outcome could jeopardize the continued existence of the company.<sup>43</sup> At least some parties may perceive arbitration as too risky for such cases because of the limited court review of arbitration awards.<sup>44</sup> In more routine cases, “knucklehead awards”<sup>45</sup> or “‘roll-the-dice’ or ‘Russian roulette’ arbitration” awards<sup>46</sup> would be just another cost of the dispute resolution process. But in high stakes cases, an aberrational award could have a devastating effect on the company, and may lead parties to avoid arbitration altogether for contracts that may give rise to such disputes.

These limitations of the arbitration process are consistent with evidence from franchise agreements.<sup>47</sup> The most common exception

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[of franchise agreements].” (quoting American Arbitration Association, Optional Rules for Emergency Measures of Protection, Rule O-1)); Dunham & Lockerby, *supra* note 10, at 15 (“In practice, however, these new procedures may suffer from significant drawbacks compared to litigation.”).

42. Relatedly, parties may be less likely to use arbitration when the typical relief sought is equitable relief—such as injunctions—because there is no right to a jury trial in such cases.

43. Alternatively, parties may provide for expanded court review of arbitration awards because of such concerns. *See, e.g.*, Alan Scott Rau, *Contracting Out of the Arbitration Act*, 8 AM. REV. INT’L ARB. 225, 245 (1997) (attributing the use of expanded review provisions to “a desire to ensure predictability in the application of legal standards, a desire to guard against a ‘rogue tribunal,’ or against the distortions of judgment that can often result from the dynamics of tripartite arbitration”). In *Hall Street Associates v. Mattel, Inc.*, the Supreme Court held that parties cannot by contract expand the grounds for review under the FAA, but did not foreclose the possibility that parties may be able to utilize other means of obtaining expanded review. 128 S. Ct. 1396, 1405-08 (2008).

44. ALAN SCOTT RAU ET AL., PROCESSES OF DISPUTE RESOLUTION: THE ROLE OF LAWYERS 603 (4th ed. 2006) (“a party for whom the stakes and risk of loss are high may for that reason become less interested in ‘informality’—and more reluctant to chance a decision without having taken every possible advantage of the full panoply of procedures, including the ability to play out his hand to the bitter end”); Stephen A. Hochman, *Judicial Review to Correct Error—An Option to Consider*, 13 OHIO ST. J. ON DISP. RESOL. 103, 104 (1997) (“[B]ecause of the uncertainties inherent in AAA arbitration and the lack of an effective means of judicial review to correct arbitral error, there are many who avoid using AAA pre-dispute arbitration clauses in their agreements . . .”).

45. Carroll E. Neesemann, *Contracting for Judicial Review: Party-Chosen Arbitral Review Standards Can Inspire Confidence in the Process, and Is Good for Arbitration*, DISP. RESOL. MAG., Fall 1998, at 18.

46. Hochman, *supra* note 44, at 104.

47. They also provide at least a partial explanation for the finding by Eisenberg & Miller that businesses ordinarily do not include arbitration clauses in various contracts disclosed in SEC filings. *See* Eisenberg & Miller, *supra* note 12, at 1981. “Material” contracts (the standard for disclosure) are more likely to involve high stakes (that is, give rise to “bet-the-company” cases) for which parties are less likely to agree to arbitration. In addition, some of the contracts are ones for which parties likely will seek emergency or injunctive relief in the event of a dispute. *See id.* at 1982 (“[D]isputes in merger contracts often will be resolved through equitable relief (for example, a

(carve-out) from arbitration in franchise agreements is for trademark disputes.<sup>48</sup> The franchisor's trademark "is the lifeblood of the business. Given the lack of appeal in most arbitrations, the risk that an arbitrator might wrongly determine the mark to be generic or invalid is too high."<sup>49</sup> The next most common exception is for actions seeking provisional remedies<sup>50</sup> (also a common remedy in trademark disputes) for which arbitration is not well suited.<sup>51</sup>

### III. WHY FLEE ARBITRATION?

Given these reasons for agreeing to arbitrate, this Part considers why parties might flee arbitration. As we use the term here, parties "flee" arbitration when they switch away from arbitration as the chosen means of dispute resolution. Thus, parties flee arbitration, not merely when they decide not to include an arbitration clause in their contract in the first place, but rather when they switch from using an arbitration clause to using a forum selection clause (or no dispute resolution clause at all) for a particular type of contract.<sup>52</sup> Accordingly, understanding why parties might flee arbitration requires identifying some change in circumstances that might lead the parties to change the chosen method of dispute resolution.

#### A. Flight by Drafting Parties

The party that drafts a standard form contract is the obvious party to examine for a flight from arbitration. It drafts the form, and thus controls whether to include an arbitration clause. Possible reasons the drafting party might flee arbitration are: (1) the party might have had some experience with arbitration that changes its view of the costs and

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motion for a preliminary injunction) . . ."). Of course, the SEC's apparent opposition to the use of arbitration in corporate by-laws, as well as the speed and certainty of the legal remedy in the event of a defaulted loan, may well provide partial explanations as well. See Park, *supra* note 39, at 222-23; Kara Scannell, *SEC Explores Opening Door to Arbitration*, WALL ST. J., Apr. 16, 2007, at A1.

48. Drahozal, *supra* note 13, at 739; see also *infra* text accompanying note 197.

49. Eileen Davis, *ADR Well-Suited to Handle Franchise Cases*, 10 ALTERNATIVES TO HIGH COST LITIG., Sept. 1992, at 130, 130.

50. Drahozal, *supra* note 13, at 739; see also *infra* text accompanying note 198.

51. Buttrick, *supra* note 8, at 18 ("Because a franchisor's ability to protect its trademark, copyrighted materials, and trade secrets is of paramount importance, it is essential that the franchisor have the ability to quickly obtain injunctive relief to protect its intellectual property. . . . Accordingly, many arbitration clauses include carve-outs to permit the parties to seek injunctive relief from a court." (footnote omitted)); Davis, *supra* note 49, at 131; Dunham & Lockerby, *supra* note 10, at 14 ("Preliminary injunctions are often the most effective (and sometimes the only) way to protect intellectual property from infringement and misappropriation.").

52. See *supra* note 12.

benefits; (2) the legal environment (governing arbitration or otherwise) might have changed; and (3) the business conditions facing the parties might have changed.

#### 1. Growing Experience with Arbitration

A drafting party decides whether to include an arbitration clause in its standard form contract based on the information available to it at the time. Once it starts using arbitration, it gains new information about the process. This new information may lead the party to readjust its views of the costs and benefits of arbitration, and may result in the party “fleeing” arbitration.

That drafting parties would reevaluate their chosen means of dispute resolution after gaining new information is not surprising. Anecdotal reports suggest that such a reevaluation is in fact taking place. According to one account: “A decade ago, many [general counsels] turned to arbitration in hopes of slicing their companies’ soaring litigation expenses; now they’re taking a second look at that decision and finding that arbitration isn’t the cure-all they’d once envisioned.”<sup>53</sup>

If, for example, a party has had a negative experience (or series of negative experiences) with arbitration, it presumably would be more likely to replace the arbitration clause in its standard form contracts with some other form of dispute resolution clause—that is, to flee arbitration. The negative experience might be with the arbitration proceeding itself (such as having the arbitration turn out to be more costly than expected, or receiving an award the party believes to be unjustified).<sup>54</sup> Or the negative experience might involve having to go to court to enforce the arbitration agreement in the first place.<sup>55</sup> In either case, the party’s experience with arbitration may induce it to flee arbitration. Of course, if the party’s experience with arbitration is positive, it would have no reason to switch to another form of dispute resolution.<sup>56</sup>

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53. Whiteman, *supra* note 4 (“Arbitration programs often were put together without a clear understanding of issues such as how the program should be designed, how an arbitrator would be selected and whether discovery would be allowed.”).

54. *Id.* (“The most frequent complaints involve not just money, but enforceability issues. Arbitration offers virtually no appellate rights, no discovery rights and no provision for summary judgment.”).

55. *Id.* (“Our company ended up investing more than a year’s worth of time and substantial legal fees simply to enforce in court our right not to have to go to court.” (quoting Jonathan B. Wilson, General Counsel, Interland, Inc.)).

56. And if the party has a negative experience with litigation, it presumably is more likely to “flee” litigation for arbitration.

## 2. Changing Legal Environment

A drafting party also might flee arbitration due to changes in the legal environment, either with respect to arbitration or otherwise. If courts become less willing to enforce pre-dispute arbitration clauses (or provisions in pre-dispute arbitration clauses), the drafting party will face a variety of additional costs: the number of challenges to clauses may increase, along with the costs of defending against those challenges; the clause itself might be declared unenforceable, with the result that the dispute will end up in court; or the arbitration process itself might change, such as by becoming more formal and “legalized,” which might reduce the benefits of arbitration to the drafting party.<sup>57</sup>

Although there continues to be an “emphatic federal policy in favor of arbitral dispute resolution,”<sup>58</sup> some courts in recent years have become more willing to invalidate arbitration clauses (or provisions in arbitration clauses).<sup>59</sup> Under section 2 of the Federal Arbitration Act (“FAA”), both pre-dispute and post-dispute arbitration agreements are “valid, irrevocable and enforceable, save upon such grounds as exist at law or in equity for the revocation of any contract.”<sup>60</sup> This general rule of enforceability applies in state court as well as federal court,<sup>61</sup> and preempts (at a minimum) state laws that invalidate arbitration agreements.<sup>62</sup> Under the savings clause of section 2, however, courts remain able to invalidate arbitration agreements using general contract law defenses.<sup>63</sup>

Perhaps the most popular ground for challenging the enforceability of arbitration agreements is the doctrine of unconscionability.<sup>64</sup> Parties cannot challenge a contract as unconscionable solely because it provides

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57. Gerald F. Phillips, *Is Creeping Legalism Infecting Arbitration?*, DISP. RESOL. J., Feb.-Apr. 2003, at 37, 38.

58. *E.g.*, *Mitsubishi Motors Corp. v. Soler Chrysler-Plymouth, Inc.*, 473 U.S. 614, 631 (1985).

59. *See* Steven J. Burton, *The New Judicial Hostility to Arbitration: Federal Preemption, Contract Unconscionability, and Agreements to Arbitrate*, 2006 J. DISP. RESOL. 469, 485-500; Susan Randall, *Judicial Attitudes Toward Arbitration and the Resurgence of Unconscionability*, 52 BUFF. L. REV. 185, 194-221 (2004); Jeffrey W. Stempel, *Arbitration, Unconscionability, and Equilibrium: The Return of Unconscionability Analysis as a Counterweight to Arbitration Formalism*, 19 OHIO ST. J. ON DISP. RESOL. 757, 799-807 (2004).

60. 9 U.S.C. § 2 (2006).

61. *Southland Corp. v. Keating*, 465 U.S. 1, 14-15 (1984).

62. Christopher R. Drahozal, *Federal Arbitration Act Preemption*, 79 IND. L.J. 393, 408-11 (2004).

63. *See* *First Options of Chicago, Inc. v. Kaplan*, 514 U.S. 938, 944 (1995) (holding that courts should “apply ordinary state-law principles that govern the formation of contracts”).

64. *See* Charles L. Knapp, *Opting Out or Copping Out? An Argument for Strict Scrutiny of Individual Contracts*, 40 LOY. L.A. L. REV. 95, 133 (2006) (crediting arbitration clauses with the “recent renaissance of unconscionability as a doctrine that can actually decide cases”).

for arbitration.<sup>65</sup> Instead, parties challenge not the obligation to arbitrate itself, but rather other provisions in the arbitration clause as unconscionable.

Courts have held a wide variety of provisions in arbitration clauses to be unconscionable or otherwise unenforceable.<sup>66</sup> The list includes clauses governing:

- Discovery limits;<sup>67</sup>
- Arbitrator selection mechanisms;<sup>68</sup>
- Class arbitration waivers,<sup>69</sup>
- Location of the arbitration proceeding;<sup>70</sup>

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65. *Doctor's Assocs., Inc. v. Casarotto*, 517 U.S. 681, 687-88 n.3 (1996); *Perry v. Thomas*, 482 U.S. 483, 492-93 n.9 (1987) (stating that a court may not “rely on the uniqueness of an agreement to arbitrate as a basis for a state-law holding that enforcement would be unconscionable, for this would enable the court to effect what we hold today the state legislature cannot”).

66. Or, in the case of statutory claims, holding an arbitration clause unenforceable as precluding the claimant from vindicating his or her statutory rights. *Burton*, *supra* note 59, at 489.

67. *E.g.*, *Ferguson v. Countrywide Credit Indus., Inc.*, 298 F.3d 778, 786-87 (9th Cir. 2002) (applying California law). *But see, e.g.*, *Caley v. Gulfstream Aerospace Corp.*, 428 F.3d 1359, 1378 (11th Cir. 2005) (applying Georgia law and rejecting challenge to discovery limitation).

68. *E.g.*, *Hooters of Am., Inc. v. Phillips*, 173 F.3d 933, 935, 938-41 (4th Cir. 1999) (material breach); *Rodriguez v. Windermere Real Estate/Wall St., Inc.*, 175 P.3d 604, 605 (Wash. Ct. App. 2008) (concluding that a dispute resolution process in which franchisor appoints all arbitrators to resolve dispute between franchisee and employee “inherently lacks neutrality” and is unenforceable). *But see, e.g.*, *Brockie v. Am. Gen. Fin. Servs., Inc.*, 2007 U.S. Dist. LEXIS 84084, at \*7-\*8 (S.D. Fla. Nov. 14, 2007) (rejecting claim that National Arbitration Forum arbitration is unconscionable on grounds of bias); *Bank One, N.A. v. Coates*, 125 F. Supp. 2d 819, 835-36 (S.D. Miss. 2001) (same).

69. *E.g.*, *Skirchak v. Dynamics Research Corp.*, 508 F.3d 49, 51 (1st Cir. 2007) (“Based on the particular facts of this case, we uphold the striking of the class action waiver on grounds of unconscionability . . .”); *Kristian v. Comcast Corp.*, 446 F.3d 25, 64 (1st Cir. 2006) (concluding that several provisions in arbitration clause, including class arbitration waiver, “would prevent the vindication of statutory rights” and severing invalid provisions); *Leonard v. Terminex Int’l Co.*, 854 So. 2d 529, 535-39 (Ala. 2002); *Discover Bank v. Superior Court*, 113 P.3d 1100, 1108 (Cal. 2005); *Tillman v. Commercial Credit Loans, Inc.*, 655 S.E.2d 362, 373 (N.C. 2008) (holding that “the provisions of the arbitration clause [including a prohibition on joinder and class actions], taken together, render it substantively unconscionable because the provisions do not provide plaintiffs with a forum in which they can effectively vindicate their rights”); *Scott v. Cingular Wireless*, 161 P.3d 1000, 1007-08 (Wash. 2007) (“We . . . conclude that since this clause bars any class action, in arbitration or without, it functions to exculpate the drafter from liability for a broad range of undefined wrongful conduct, including potentially intentional wrongful conduct, and that such exculpation clauses are substantively unconscionable.”). *But see, e.g.*, *Iberia Credit Bureau v. Cingular Wireless L.L.C.*, 379 F.3d 159, 174-75 (5th Cir. 2004); *Livingston v. Assocs. Fin., Inc.*, 339 F.3d 553, 559 (7th Cir. 2003); *Snowden v. CheckPoint Check Cashing*, 290 F.3d 631, 638-39 (4th Cir. 2002); *Johnson v. West Suburban Bank*, 225 F.3d 366, 377-78 (3d Cir. 2000); *Stenzel v. Dell, Inc.*, 870 A.2d 133, 144 (Me. 2005) (applying Texas law); *see also Spann v. Am. Express Travel Related Servs. Co.*, 224 S.W.3d 698, 714-15 (Tenn. Ct. App. 2006) (“[W]ith the exception of courts sitting in California, the vast majority of state and federal courts that have considered the question have rejected the argument that class action and class arbitration waiver clauses are unconscionable per se.”).

- Cost allocation;<sup>71</sup>
- Time limits;<sup>72</sup>
- Remedy limitations;<sup>73</sup>
- Carve-outs from arbitration;<sup>74</sup> and
- Confidentiality.<sup>75</sup>

In some cases, the courts sever the unenforceable provision (or provisions) and send the dispute to arbitration; in other cases, the courts refuse to sever the unenforceable provision and invalidate the entire arbitration clause.<sup>76</sup> In many cases, of course, an equal or greater number of courts have held virtually identical provisions not to be unconscionable.<sup>77</sup>

70. *E.g.*, *Williams v. Aetna Fin. Co.*, 700 N.E.2d 859, 866 (Ohio 1998). *But see, e.g.*, *Doctor's Assocs., Inc. v. Stuart*, 85 F.3d 975, 980 (2d Cir. 1996) (upholding location provision in franchise agreement).

71. *E.g.*, *Circuit City Stores, Inc. v. Adams*, 279 F.3d 889, 894 (9th Cir. 2002). *See generally* Christopher R. Drahozal, *Arbitration Costs and Contingent Fee Contracts*, 59 VAND. L. REV. 729, 750-57 (2006) (reporting results of empirical study of cost-based challenges to arbitration clauses finding that “the vast majority of cost-based challenges to arbitration agreements were unsuccessful”).

72. *E.g.*, *Davis v. O'Melveny & Myers*, 485 F.3d 1066, 1076-78 (9th Cir. 2007) (applying California law and holding that a one-year time limit for bringing claims is unconscionable); *Alexander v. Anthony, Int'l, L.P.*, 341 F.3d 256, 266-67 (3d Cir. 2003) (finding a 30-day notice requirement unconscionable). *But see, e.g.*, *Bar-Ayal v. Time Warner Cable Inc.*, 2006 U.S. Dist. LEXIS 75972, at \*60 (S.D.N.Y. Oct. 16, 2006) (rejecting unconscionability challenge to one-year time limit).

73. *E.g.*, *State ex rel. Dunlap v. Berger*, 567 S.E.2d 265, 278-80 (W. Va. 2002). *But see, e.g.*, *Overstreet v. Contigroup Cos.*, 462 F.3d 409, 412 n.2 (5th Cir. 2006) (applying Georgia law and upholding a waiver of punitive damages).

74. *E.g.*, *E-Z Cash Advance, Inc. v. Harris*, 60 S.W.3d 436, 442 (Ark. 2001) (lack of mutuality); *Armendariz v. Found. Health Psychcare Servs., Inc.*, 6 P.3d 669, 694 (Cal. 2000). *But see, e.g.*, *Caley v. Gulfstream Aerospace Corp.*, 428 F.3d 1359, 1378 (11th Cir. 2005) (applying Georgia law and rejecting a challenge for lack of mutuality). *See generally* Christopher R. Drahozal, *Nonmutual Agreements to Arbitrate*, 27 J. CORP. L. 537, 547 (2002) (“the majority of courts . . . hold that nonmutual arbitration clauses are not unconscionable”).

75. *E.g.*, *Ting v. AT&T*, 319 F.3d 1126, 1151-52 (9th Cir. 2003) (applying California law). *But see, e.g.*, *Iberia Credit Bureau, Inc. v. Cingular Wireless L.L.C.*, 379 F.3d 159, 175-76 (5th Cir. 2004) (applying Louisiana law and upholding a confidentiality provision).

76. *Booker v. Robert Half Int'l, Inc.*, 413 F.3d 77, 84-86 (D.C. Cir. 2005) (Roberts, J.).

77. *See* cases cited *supra* notes 67-75. For a skeptical view of unconscionability in the arbitration context, see *Carbajal v. H & R Block Tax Services, Inc.*, 372 F.3d 903, 906 (7th Cir. 2004) (Easterbrook, J.) (“The cry of ‘unconscionable!’ just repackages the tired assertion that arbitration should be disparaged as second-class adjudication. . . . People are free to opt for bargain-basement adjudication—or for that matter, bargain-basement tax preparation services; air carriers that pack passengers like sardines but charge less; and black-and-white television. In competition, prices adjust and both sides gain. ‘Nothing but the best’ may be the motto of a particular consumer but is not something the legal system foists on all consumers.”) and *IFC Credit Corp. v. United Business & Industrial Federal Credit Union*, 512 F.3d 989, 993 (7th Cir. 2008) (Easterbrook, C.J.) (“If buyers prefer juries, then an agreement waiving a jury comes with a lower price to compensate buyers for the loss. . . . As long as the price is negotiable and the customer may shop elsewhere, consumer protection comes from competition rather than judicial intervention.”).

Most of the unconscionability cases involve arbitration clauses in consumer and employment contracts, rather than franchise contracts. But in *Nagrampa v. MailCoups, Inc.*,<sup>78</sup> the United States Court of Appeals for the Ninth Circuit applied the doctrine of unconscionability to invalidate an arbitration clause in a franchise agreement;<sup>79</sup> the California Court of Appeal previously had done the same.<sup>80</sup> At least some franchise lawyers fear that “[t]he *Nagrampa* ruling and similar California decisions could be a precursor for courts in California or elsewhere to extend that line of thinking to invalidate other aspects of franchise contracts.”<sup>81</sup>

In addition to changes in the legal environment governing the enforceability of arbitration clauses, other changes in the legal environment might also cause a flight from arbitration. For example, one reason parties might agree to arbitrate is to reduce the risk of excessive punitive damages awards.<sup>82</sup> If, say as a result of United States Supreme Court cases recognizing due process limits on punitive damages awards,<sup>83</sup> drafting parties perceive that the risk of excessive punitive damages awards in court has decreased, they may be less likely to use arbitration to resolve their disputes.<sup>84</sup>

### 3. Changing Business Conditions

A final reason the drafting party might flee arbitration is because of changes in the business conditions facing the parties. In the franchise industry, the growth and maturity of the franchise system over time are possible reasons a franchisor might change its view of arbitration. Drahozal and Hylton found no effect of maturity on the use of arbitration, but did find that franchisors with growing networks were less

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78. 469 F.3d 1257 (9th Cir. 2006) (en banc).

79. *Id.* at 1294.

80. *Indep. Ass’n of Mail Box Ctr. Owners v. Mail Boxes Etc., USA, Inc.*, 34 Cal. Rptr. 3d 659, 676 (Ct. App. 2005); *see also* *McGuire v. Coolbrands Smoothies Franchise L.L.C.*, No. H030202, 2007 WL 2381545, at \*15 (Cal. Ct. App. Aug. 22, 2007).

81. Marek, *supra* note 7, at 9 (paraphrasing comments by Carmen Caruso, then of Schwartz Cooper in Chicago, Ill.); *see also* Barry M. Heller & Peter Lagarias, *Navigating Nagrampa: Drafting and Contesting the Arbitration Clause 15* (Oct. 10-12, 2007) (unpublished paper, prepared for the ABA 30th Annual Forum on Franchising) (on file with the Hofstra Law Review) (“Mr. Heller believes that other states will not adopt the *Nagrampa* approach . . . Mr. Lagarias believes that the application of basic unconscionability principles, endemic to virtually all states, will likely result in contests to arbitration clauses in franchise agreements.”).

82. Drahozal & Hylton, *supra* note 6, at 574.

83. *E.g.*, *State Farm Mut. Auto. Ins. Co. v. Campbell*, 538 U.S. 408, 425, 429 (2003); *BMW of N. Am., Inc. v. Gore*, 517 U.S. 559, 585-86 (1996).

84. *Dunham & Lockerby*, *supra* note 10, at 26 (“Given the current state of the law, every franchisor’s operating assumption should be that those [constitutional] standards do *not* apply to arbitration awards, including judicial orders confirming those awards.”).

likely to include arbitration clauses in their contracts, at least for franchises with relatively little repeat business.<sup>85</sup> Or the acquisition of the franchisor or a change in the law firm representing the franchisor might prompt a reconsideration of the provisions in the franchise agreement, including the dispute resolution clause.

### B. *Flight by Non-Drafting Parties*

Although commentators have focused on the drafting party, the non-drafting party also might “flee” arbitration. Non-drafting parties might prefer to enter into contracts without arbitration clauses; if so, the market might penalize firms that use arbitration clauses. At some point one would expect the drafting party to revise its contract to remove the arbitration clause (that is, for the drafting party to flee arbitration). But until that happens, flight from arbitration might manifest itself in a declining market share for drafting parties that use arbitration clauses.

Whether flight by non-drafting parties is likely to occur underlies much of the debate over consumer and employment (and franchise) arbitration. Critics argue that consumers and employees do not meaningfully consent to arbitration clauses in standard form contracts because they do not know the clauses are there, do not understand the clauses if they notice them, and have no choice but to enter into the agreement.<sup>86</sup> As a result, the critics assert, the market does not constrain the abusive use of arbitration clauses by businesses.<sup>87</sup> Supporters of consumer and employment arbitration, by contrast, have more faith in the market as a means of ensuring that consumers benefit from arbitration.<sup>88</sup>

Regardless of one’s views on consumer and employment arbitration, franchisees differ from consumers and employees in several important respects. First, franchisees are business people, and at least some franchisees are very sophisticated business people—including

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85. Drahozal & Hylton, *supra* note 6, at 575-77. Another possible change in business conditions that might affect the use of arbitration clauses is the acquisition of a franchisor by a party with a different view of the costs and benefits of arbitration.

86. See Drahozal, *supra* note 13, at 706-07; Eisenberg et al., *supra* note 28, at 872-73; Schwartz, *supra* note 2, at 56-57.

87. Schwartz, *supra* note 2, at 58-60; Sternlight, *Panacea*, *supra* note 2, at 686-93; Jean R. Sternlight & Elizabeth J. Jensen, *Using Arbitration to Eliminate Consumer Class Actions: Efficient Business Practice or Unconscionable Abuse?*, 67 *LAW & CONTEMP. PROBS.* 75, 92-99 (2004).

88. Peter B. Rutledge, *Wither Arbitration?*, 6 *GEO. J.L. & PUB. POL’Y* 549 (2008); Stephen J. Ware, *Paying the Price of Process: Judicial Regulation of Consumer Arbitration Agreements*, 2001 *J. DISP. RESOL.* 89, 91-93; Stephen J. Ware, *The Case for Enforcing Adhesive Arbitration Agreements—with Particular Consideration of Class Actions and Arbitration Fees*, 5 *J. AM. ARB.* 251, 254-57 (2006).



publicly-traded companies.<sup>89</sup> Second, the market for franchise opportunities is highly competitive, and franchisees have the option to choose between franchisors that use arbitration and those that do not.<sup>90</sup> Third, state franchising laws and Federal Trade Commission regulations provide for conspicuous notice of arbitration clauses (as well as clauses specifying the location of the arbitration or court proceeding) in franchise disclosure documents made available to franchisees before they purchase the franchise.<sup>91</sup> Indeed, some states require the franchisor to register and make the disclosure documents publicly available before the franchisor can sell franchises in the state.<sup>92</sup> For all these reasons, in our view, a market response to arbitration clauses by franchisees is even more likely than by consumers and employees.<sup>93</sup>

Nonetheless, how well the market works ultimately is an empirical question, which we do not purport to answer here. Thus, any absence of flight by non-drafting parties is ambiguous. One possible interpretation would be that non-drafting parties do not flee arbitration because they benefit from pre-dispute arbitration clauses. Another possible interpretation would be that non-drafting parties do not flee arbitration because they do not know about or do not understand the significance of arbitration clauses in standard form contracts.

### C. *Modifying Arbitration Clauses as an Alternative to Flight*

An alternative response to fleeing arbitration altogether is for the drafting party to modify its arbitration clause to address the reasons for

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89. *E.g.*, *Broussard v. Meineke Disc. Muffler Shops, Inc.*, 155 F.3d 331, 348 (4th Cir. 1998) (“By all lights, Meineke franchisees are independent, sophisticated, if sometimes small, businessmen who dealt with Meineke at arms’ length and pursued their own business interests.”); Franchise Rule, 64 Fed. Reg. 57,320 (proposed Oct. 22, 1999) (“[C]ommenters note that franchising today may involve heavily-negotiated, multi-million dollar deals between franchisors and highly sophisticated individual and corporate franchisees who are represented by counsel.”).

90. Benjamin Klein, *Market Power in Franchise Cases in the Wake of Kodak: Applying Post-Contract Hold-Up Analysis to Vertical Relationships*, 67 ANTITRUST L.J. 283, 286 (1999) (“Because potential franchisees have many choices available pre-contract, franchisors have no market power when negotiating franchise contracts.”); *see infra* text accompanying notes 112-18.

91. Drahozal, *supra* note 13, at 766-67. On March 30, 2007, the Federal Trade Commission adopted a new Franchise Rule, which modifies some of the requirements for franchise disclosure documents. *See generally* 72 Fed. Reg. 15,444 (Mar. 30, 2007) (amending 16 C.F.R. § 436 (1986)). The rule permits franchisors to follow the previous requirements until July 1, 2008. *Id.*

92. *See* Fed. Trade Comm’n, State Offices Administering Franchise Disclosure Laws, <http://www.ftc.gov/bcp/franchise/netdiscl.shtm> (last visited Jan. 15, 2009) (listing California, Hawaii, Illinois, Indiana, Maryland, Michigan, Minnesota, New York, North Dakota, Oregon, Rhode Island, South Dakota, Virginia, Washington, and Wisconsin).

93. Which does not necessarily mean that there is no market response for consumers and employees.

its dissatisfaction with arbitration. The type of drafting response will vary with the reason or reasons for the drafting party's dissatisfaction.

One possible reason is dissatisfaction with the arbitration process itself. The party's experience with arbitration may lead it to believe that arbitration is not as fast and inexpensive as it once believed, for example.<sup>94</sup> Or the party may have received what it perceives to be an unjustified or aberrational award by the arbitrator. Possible drafting responses include: (1) changing the arbitration rules specified in the contract to those promulgated by a different (lower-cost) provider; (2) changing the number of arbitrators (capping the number at one if cost is the concern; providing for a three-arbitrator panel if arbitrator decisionmaking is the issue);<sup>95</sup> (3) limiting discovery; and (4) providing for some sort of appeals process or expanding the grounds on which courts can review awards. The tradeoff between these sorts of changes should be clear: Changes that reduce the risk of aberrational awards (such as increasing the number of arbitrators or providing for expanded judicial review) are likely to increase cost, and vice versa.<sup>96</sup>

Another possible reason for concern is the process for enforcing the arbitration agreement. As discussed above, some courts have held provisions in arbitration clauses unconscionable, either invalidating the entire arbitration clause or else striking the offending provision and then sending the case to arbitration under the arbitration clause as modified.<sup>97</sup> Drafting parties may respond to such court decisions by modifying the arbitration clause to remove or alter the potentially objectionable provisions. Several franchising lawyers have predicted that such changes are likely to occur after the Ninth Circuit's decision in *Nagrampa*.<sup>98</sup>

#### D. Summary and Recap

The rest of this Article will test three sets of questions concerning the "flight" from arbitration:<sup>99</sup>

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94. Whiteman, *supra* note 4 ("One of the main complaints is the expense. If the opposing party demands a trial, the resulting court sessions can easily run up a six-figure tab before any of the original issues are resolved.").

95. See *infra* text accompanying notes 150-51.

96. See *infra* text accompanying notes 158-59.

97. See *supra* text accompanying notes 66-76.

98. Heller & Lagarias, *supra* note 81, at 15 ("Franchisors with a significant number of franchisees based in California will most likely redraft any arbitration clauses in their agreements to seek to avoid the bases upon which the *Nagrampa* Court voided the clause there."); Marek, *supra* note 7, at 9 ("[S]ome attorneys . . . believe that franchisors will simply fine-tune arbitration clauses to conform with recent decisions.").

99. One possibility that we do not investigate is whether the franchisor and franchisee agree to waive the contractual arbitration agreement after a dispute arises, what might be called "post-

1. Are franchisors fleeing arbitration—that is, have franchisors replaced the arbitration clauses in their franchise agreements with some other form of dispute resolution clause?

2. Are franchisees fleeing arbitration—that is, has the share of franchised units for franchisors with arbitration clauses in their franchise agreements declined relative to those with other types of dispute resolution clauses?

3. Are franchisors modifying the arbitration clauses in their franchise agreements either (a) to remove or alter provisions in response to the franchisor's dissatisfaction with the arbitration process; or (b) to remove or alter provisions that courts have held unconscionable or otherwise unenforceable?

#### IV. IS THERE A FLIGHT FROM ARBITRATION?

This Part of the Article tests empirically whether parties are fleeing arbitration, or otherwise modifying their arbitration clauses, in response to their dissatisfaction with arbitration. We compare the dispute resolution clauses in a sample of franchise agreements from the same franchisors in 1999 and 2007 to determine the extent to which, if at all, the franchisors changed the clauses over time. We find little evidence that franchisors as a whole have fled arbitration, although some franchisors have eliminated arbitration clauses from their franchise agreements (while others have added arbitration clauses). Nor do we find any evidence of a “flight” from arbitration by franchisees. Franchisors have modified their arbitration clauses to some degree. The most common changes have been to add a class arbitration waiver and to provide for one arbitrator instead of three.<sup>100</sup> Class arbitration waivers arguably evidence a slight, partial flight from arbitration and reducing the number of arbitrators signifies franchisor efforts to hold down the cost of the arbitration process.

##### A. Sample and Data

The sample consists of seventy-five leading franchisors that were ranked at the top of *Entrepreneur Magazine's Franchise 500* in 1999 and that had franchise disclosure documents on file with the Minnesota Department of Commerce at the time.<sup>101</sup> The dispute resolution clauses

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dispute flight from arbitration.” We have no indications that this is happening on any widespread basis, and have no data we can use to examine the possibility.

100. See *infra* tbls.8 & 11.

101. Drahozal, *supra* note 13, at 722-24. Minnesota is one of a minority of states that require franchisors to register with the state before selling franchises there. MINN. STAT. ANN. § 80C.02

from the 1999 franchise agreements were collected that year; the results of that study previously have been published.<sup>102</sup> For this Article, we collected the dispute resolution clauses for the same franchisors for 2007 from the Minnesota Department of Commerce, giving us a basis for identifying changes in the clauses over time. Although we collected the data in Minnesota, the franchise agreements we examined (with one exception) were standard form contracts used by franchisors on a national basis.<sup>103</sup>

Our current sample consists of seventy-one of the original seventy-five franchisors. Since the original study, one of the franchisors merged into another (Q Lube merged into Jiffy Lube, with all Q Lube locations becoming Jiffy Lubes<sup>104</sup>), and thus is removed from the sample as a separate observation. In addition, five other franchisors are no longer registered in Minnesota,<sup>105</sup> so that the current disclosure documents and franchise agreements are no longer available from the Minnesota Department of Commerce. Of those five, we were able to obtain the franchise documents of two from an online database of franchise filings

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(West 1999). At the time the data were collected, the required registration materials included a Uniform Franchise Offering Circular (containing detailed information about the franchisor and the franchised business) and a copy of the franchise agreement, which were the source of most of the data used in this study. MINN. R. 2860.3500(15)-3800 (2007). We are aware of no relevant change in Minnesota franchise law during the period studied. As noted above, on March 30, 2007, the Federal Trade Commission modified its Franchise Rule, including its disclosure requirements. *See supra* note 91. We saw no indication that franchisors were already following the amended disclosure requirements in the disclosure documents we examined, and even if they were, the amended requirements would not have affected our results.

102. *See generally* Drahozal, *supra* note 13; Drahozal & Hylton, *supra* note 6. For an extension of the earlier study, see William L. Killion, *An Informal Study of Arbitration Clauses Reveals Surprising Results*, 22 FRANCHISE L.J. 79, 79 (2002) (“I looked at the dispute resolution provisions in the franchise agreements for the next fifty franchises in the *Entrepreneur* listing on file with the [Minnesota Department of Commerce]. Thirty-six contain arbitration clauses while fourteen do not. Thus, 72 percent of the franchise agreements contain commitments to arbitrate.”).

103. The agreements do vary by state, but the variations are reflected in state-specific addenda attached to the standard form franchise agreements. *See infra* note 136. For the one exception, see *infra* note 107.

104. J. Dee Hill, *Jiffy Lube Showdown*, ADWEEK, Nov. 1, 1999, available at [http://www.adweek.com/aw/eseach/article\\_display.jsp?vnu\\_content\\_id=532701](http://www.adweek.com/aw/eseach/article_display.jsp?vnu_content_id=532701).

105. The five that are no longer registered in Minnesota are CD Warehouse, Inc., Century Small Business (acquired by Fiducial), Padgett Business Services, Pizza Inn, Inc., and Yogen Früz U.S.A. Inc. In addition, since 1999, the Prudential Real Estate Brokerage Franchise Agreement had been replaced by two new filings: the Prudential Real Estate Affiliates, Inc. Franchise Agreement and the Prudential Commercial Real Estate Brokerage Franchise Agreement. The dispute resolution clauses in the latter two franchise agreements are identical and so did not affect the results here. In reporting the number of Prudential franchisees in Table 6, *see infra* text accompanying note 127, we combined the numbers for both (which was immaterial anyway because there were only thirty-two Prudential commercial real estate brokerage franchisees in 2007).

maintained by the California Department of Corporations.<sup>106</sup> For each franchise agreement, we classified the dispute resolution clause and various provisions of the dispute resolution clause, as discussed below.<sup>107</sup>

Tables 3, 4, and 5 provide summary information on the franchises in the sample.<sup>108</sup> The franchises studied provide a cross-section of the franchise industry—as to the product or service provided, the year the franchisor began franchising, and the number of franchised units. Although the *Franchise 500* is a widely used source of data for research on franchising,<sup>109</sup> it is not a representative sample of all franchises. As

106. Cal. Dep't of Corps., California Electronic Access to Securities Information and Franchise Information, <http://134.186.208.228/caleasi/pub/exsearch.htm> (enter company name in the search field) (last visited Jan. 15, 2009). From the California database, we were able to obtain a copy of dispute resolution clauses from the Century Small Business (Fiducial) franchise agreement (from a Franchise Registration filing dated March 14, 2005) and the Yogen Früz U.S.A. Inc. franchise agreement (from a Franchise Registration filing dated December 14, 2007). Unfortunately for our purposes, California exempts all franchisors above a certain size from state filing requirements, so that virtually all of the franchisors in our sample need file only a request for exemption, and not a disclosure document and franchise agreement, with the State.

107. The one franchise agreement that was difficult to characterize was that of Jani-King (commercial cleaning). In 1999, the Jani-King franchise agreement contained an exclusive forum selection clause. Jani-King, Associate Franchise Agreement ¶ 11.10, at 20 (1999) (on file with the Hofstra Law Review). In 2007, the franchise agreement—with Jani-King of Minnesota, Inc. as the franchisor—contained no dispute resolution clause. *See generally* Jani-King of Minnesota, Inc., Franchise Agreement 20 (2006) (on file with the Hofstra Law Review). Jani-King apparently now uses a different corporate entity for each state's franchises. As a result, there is little need to specify an exclusive forum for dispute resolution, since all disputes would be between a Minnesota franchisor and a Minnesota franchisee. In effect, even in the absence of a clause, the franchise agreement likely functions much the same as if it had an exclusive forum selection clause, and so we classified it as such.

108. Because the sample includes almost all of the franchises in the original article, Tables 1 and 2 are almost identical to those in Drahozal, *supra* note 13, at 725. Table 3 differs to a greater degree, principally because the data available at the time of the earlier study included not only United States franchises, but worldwide franchises. For this Article, we use only data on the number of United States franchised locations.

109. For examples, see Jonathan Klick et al., *The Effect of Contract Regulation: The Case of Franchising* 18 (Fla. State Univ. College of Law, Law & Econ. Paper No. 07/001, 2006), available at <http://ssrn.com/abstract=951464> (“We chose those fast food firms that ranked most highly on *Entrepreneur Magazine's* Franchise 500 which satisfied the data availability constraint.” (footnote omitted)); Bruce H. Kobayashi & Larry E. Ribstein, *Contract and Jurisdictional Freedom*, in *THE FALL AND RISE OF FREEDOM OF CONTRACT* 344 & nn.134, 137 (F.H. Buckley ed., 1999) (relying on an “*Entrepreneur Magazine* sample”). For discussions of potential biases (or lack thereof) in using the *Franchise 500* as a data source, see, for example, John E. Clarkin & Robert B. Hasbrouck, *The Franchise 500 as a Research Tool: How Objective and Reliable Is It?*, 14 J. SMALL BUS. & ENTERPRISE DEV. 144, 145 (2007) (“The number of respondents to the magazine’s survey indicates an apparent willingness by franchisors to participate . . . . [T]he dataset has been found to be comparable to other respected sources of franchise information.”); James G. Combs & Gary J. Castrogiovanni, *Franchisor Strategy: A Proposed Model and Empirical Test of Franchise Versus Company Ownership*, J. SMALL BUS. MGMT., Apr. 1994, at 37, 42 (“Bias [in inclusion in the Franchise 500], however, seems minimal because franchisors have considerable incentive to be

can be seen in Tables 2 and 3, it tends to include larger, more established franchises.<sup>110</sup> If franchisors of newer and smaller franchises are more likely to make changes to their franchise agreements, perhaps because their smaller franchisee base leaves them less locked-in to existing franchising agreements,<sup>111</sup> we may not be observing the sorts of franchises where a flight from arbitration is most likely to take place. Conversely, however, if a flight from arbitration takes place only among small or new franchises, it affects a much smaller body of contracts than if flight were occurring among larger and more established franchises.

Table 1. Product or Service Provided	
Food Service & Restaurants	24
Various Retail	9
Business & Accounting Services	8
Cleaning Services	6
Travel Services	6
Automobile Services	5
Hair Care Services	4
Real Estate	3
Fitness Center	2
Training Services	2
Other	2

Table 2. Year Began Franchising	
1990s	6
1980s	29

listed . . ."); Francine Lafontaine, *A Critical Appraisal of Data Sources on Franchising*, in *FRANCHISING: CONTEMPORARY ISSUES AND RESEARCH* 5, 15 (Patrick J. Kaufmass & Rajiv P. Dant, eds., 1995) (describing *Entrepreneur Magazine's Franchise 500* as providing "the most detailed longitudinal data set on individual franchisors").

110. See Gary J. Castrogiovanni et al., *Franchise Failure Rates: An Assessment of Magnitude and Influencing Factors*, *J. SMALL BUS. MGMT.*, Apr. 1993, at 105, 106 (comparing a random sample of franchisors selected from the directory of the International Franchise Association to those listed in *Entrepreneur Magazine* and finding that "sample members tended to be older and larger [than those listed in *Entrepreneur Magazine*]," although "those age and size differences were not statistically significant"); Lafontaine, *supra* note 109, at 6-7 ("the sample of franchisors for which detailed data are available are biased toward larger and older franchisors, as well entrants [into franchising]").

111. Of course, as seen *infra* Part IV.D, the franchisors in our sample do make changes to their dispute resolution clauses, so any lock-in of larger franchisors is not absolute.

1970s	15
1960s	11
1950s	6
1940s	2
1930s	1
1920s	1

Table 3. Number of Franchises, 2006	
<500	16
500-1000	18
1000-2000	14
2000-3000	7
3000-4000	1
4000-5000	7
5000-10,000	6
>10,000	2

### B. *Are Franchisors Fleeing Arbitration?*

Based on our sample, we find little evidence that franchisors as a whole are fleeing arbitration by removing arbitration clauses from their franchise agreements. The percentage of franchisors in the sample that used arbitration clauses declined only slightly between 1999 and 2007.<sup>112</sup> Of the seventy-one franchisors for which we were able to obtain the dispute resolution clause for both years, 45.1% (thirty-two of seventy-one) included an arbitration clause in 1999 and 43.7% (thirty-one of seventy-one) included an arbitration clause in 2007.<sup>113</sup> Stated otherwise, on net, one fewer franchisor in the sample used an arbitration clause in 2007 than in 1999. By comparison, the use of exclusive forum selection clauses increased more substantially—from 38.0% (twenty-seven of seventy-one) in 1999 to 45.1% (thirty-two of seventy-one) in 2007.<sup>114</sup>

Even the slight decline in the number of franchisors using arbitration clauses is misleading because of a change in the sample noted above. Q Lube, an oil change service franchisor, was included in the

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112. *See infra* tbl.4.

113. *See infra* tbl.4. These results are updated slightly from preliminary results reported in the *National Law Journal* in August 2007. *See* Marek, *supra* note 7, at 8 (“About 45% of major U.S. franchisors mandated arbitration in the agreements they signed last year with franchisees, according to preliminary research by Christopher Drahozal, a law professor at the University of Kansas. That’s about the same as the figure Drahozal found based on 1999 data in earlier research . . .”). Since that story was published, we have been able to track down the dispute resolution clauses of several additional franchise agreements in the original sample; hence, the slightly different percentages from the preliminary results reported previously. The preliminary results do not differ materially from our current results.

114. *See infra* tbl.4.



1999 sample, and its franchise agreement contained an exclusive forum selection clause.<sup>115</sup> Q Lube is not included in the 2007 sample because it was merged with Jiffy Lube International, Inc. After the acquisition, all former Q Lube franchises were converted into Jiffy Lube franchises.<sup>116</sup> As a result, those franchisees presumably are now governed by the Jiffy Lube franchise agreement—which includes an arbitration clause. Effectively, the exclusive forum selection clause in the 1999 Q Lube agreement has been switched to an arbitration clause.<sup>117</sup> Again, because Q Lube no longer exists as a separate franchisor, the switch does not appear in the results reported in Table 4. But had we done so, both the number and the percentage of franchisors using arbitration clauses would have been unchanged from 1999 to 2007.<sup>118</sup>

	1999	2007
Arbitration Clause	32 (45.1%)	31 (43.7%)
Exclusive Forum Selection Clause	27 (38.0%)	32 (45.1%)
Nonexclusive Forum Selection Clause	4 (5.6%)	5 (7.0%)
No Dispute Resolution Clause	8 (11.3%)	3 (4.2%)

So far, we have been describing aggregate results—the overall percentage of franchisors that include an arbitration clause in their franchise agreement. Table 5 lists the number of franchisors who switched the form of dispute resolution clause in their franchise agreement between 1999 and 2007. As Table 5 shows, although on net there has been little change in the frequency of arbitration clauses, a number of franchisors in fact switched their dispute resolution clauses.

115. See *infra* tbl.4 (noting results of that study).

116. See *supra* text accompanying note 104.

117. See Hill, *supra* note 104; *supra* text accompanying note 104; see also *infra* tbl.4 (documenting results of the study).

118. Note that the percentage of franchisors that use arbitration clauses is not equivalent to the percentage of franchise agreements that include arbitration clauses. The number of franchised units varies across franchisors. Drahozal, *supra* note 13, at 773-75. Not all franchisees for a particular franchisor necessarily have the same dispute resolution clause in their franchise agreement. See *infra* note 125.

Of the thirty-two franchisors that included an arbitration clause in their franchise agreements in 1999, four (or 12.5%) had replaced it with an exclusive forum selection clause by 2007.<sup>119</sup> At the same time, three of the eight (37.5%) franchisors with no dispute resolution clause had added an arbitration clause,<sup>120</sup> so that on net there was little change in the use of arbitration clauses. This reshuffling may explain some of the anecdotal reports of a flight from arbitration.<sup>121</sup>

One limitation of our data is that we do not know the timing of the switches. The franchisors switching away from arbitration may have made the change more recently than the franchisors switching to arbitration. If so, there would have been some flight from arbitration not visible from our data. Conversely, the franchisors switching to arbitration may have made the change more recently than the franchisors switching away from arbitration. In that case, there would in fact be a flight to arbitration. Unfortunately, our data do not permit us to determine whether either of these scenarios in fact has occurred.<sup>122</sup>

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119. See *infra* tbl.5.

120. See *infra* tbl.5.

121. A possible extension of this Article would be to examine the reasons why the franchisors that switched away from arbitration did so. Some simple quantitative analysis may be possible—such as comparing the switching franchisors to (1) other switching franchisors; (2) franchisors in the group switched from; and (3) franchisors in the group switched to, with respect to a number of characteristics: average size, growth rate, percent of company-owned outlets, high versus low externality business, whether it had been acquired, and so forth. Because of the small number of franchisors that changed dispute resolution clauses during the period studied, however, the quantitative analysis may not provide meaningful results.

122. By comparison, in examining the use of arbitration clauses in executive employment contracts, Thomas et al. find “an upward trend in the use of arbitration over time from a low of 35.9% of contracts in 1997 to 60.4% of contracts in 2005.” Thomas et al., *supra* note 16, at 21.

Table 5. Changes in Clauses, 1999-2007
<i>Arbitration Clause: Net Change -1</i> From No Dispute Resolution Clause +3 To Exclusive Forum Selection Clause -4
<i>Exclusive Forum Selection Clause: Net Change +5</i> From Arbitration Clause +4 From No Dispute Resolution Clause +1
<i>Nonexclusive Forum Selection Clause: Net Change +1</i> From No Dispute Resolution Clause +1
<i>No Dispute Resolution Clause: Net Change -5</i> To Arbitration Clause -3 To Exclusive Forum Selection Clause -1 To Nonexclusive Forum Selection Clause -1

At bottom, although there are some limitations to our data, we find little evidence that franchisors are fleeing arbitration. The percentage of franchise agreements that included arbitration clauses has declined only slightly (from 45.1% to 43.7%) since 1999,<sup>123</sup> and those data do not reflect the acquisition of one franchisor by another that effectively resulted in a switch to arbitration for the acquired franchisor. That said, the aggregate data mask the fact that some franchisors (four of thirty-two, or 12.5%) did flee arbitration for litigation, while other franchisors fled litigation for arbitration, leaving the overall use of arbitration clauses largely unchanged.<sup>124</sup>

### C. Are Franchisees Fleeing Arbitration?

The parties that draft standard form contracts are not the only ones that might flee arbitration. In addition, the non-drafting parties—those presented with standard form contracts to sign—might also flee

123. See *supra* tbl.4.

124. A June 2008 article in the *Wall Street Journal* quotes an in-house attorney for Kahala Corp., the franchisor for Blimpie submarine sandwiches, as stating that Kahala “favors resolving issues with franchisees in court.” Gibson, *supra* note 7, at B7. The 2007 Blimpie franchise agreement is one of those in our sample that included an arbitration clause. Following up on the *Wall Street Journal* article, we examined the 2008 Blimpie franchise agreement and found that it, indeed, now contains an exclusive forum selection clause instead of an arbitration clause. Kahala Franchise Corp., Blimpie Franchise Agreement ¶ 16.3, at 47 (2008) (on file with the Hofstra Law Review). Thus, one additional franchisor has switched away from arbitration subsequent to the time period we studied.

arbitration. This flight might manifest itself in decisions by the drafting party to stop using a pre-dispute arbitration clause. In other words, flight by non-drafting parties might induce flight by drafting parties. As discussed above, there is little evidence of such flight.

But flight by non-drafting parties might also manifest itself in a decline in the number of contracts entered into with drafting parties that use arbitration clauses. If the non-drafting parties prefer standard form contracts without arbitration clauses, one would expect (all else being equal) some decline in the number of contracts with arbitration clauses—at least relative to the number of contracts with other dispute resolution clauses.

The number of franchised units for each franchise system is not a perfect measure of the number of franchise agreements with a particular type of dispute resolution clause.<sup>125</sup> Nor is the change in the number of franchised units a perfect measure of whether there is a flight from arbitration.<sup>126</sup> Nonetheless, examining the change in the number and percentage of franchised units for franchisors with each type of dispute resolution clause provides a very simple test for whether there has been flight from arbitration.

Table 6 reports the results. This Table summarizes the number of franchised units for all franchisors using each type of dispute resolution clause in 2000 and 2006.<sup>127</sup> The number of franchised units in systems in which the franchisor included an arbitration clause in its franchise agreement increased from 57,401 to 76,166, or by 32.7%, from 1999 to 2006.<sup>128</sup> As a percentage of all franchised locations, the share of franchised units in systems with arbitration clauses increased from 43.3% to 46.0% over the same time period.<sup>129</sup> Although the share of franchise locations in systems with exclusive forum selection clauses increased significantly more (from 30.5% to 39.1%),<sup>130</sup> that hardly evidences a flight from arbitration.

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125. For example, in 1996, only 58% of Dairy Queen franchisees involved in class action litigation with the company had franchise agreements that included arbitration clauses; the remaining 42% did not. *Collins v. Int'l Dairy Queen, Inc.*, 168 F.R.D. 668, 677 (M.D. Ga. 1996).

126. A better measure would be to examine changes in the number of new franchises together with the number of renewals of franchise agreements for each franchisor. But we do not have those data for all the necessary years.

127. We used data from 2000 because unlike the available data from 1999, the data from 2000 reported United States franchised units rather than worldwide franchised units. *See supra* note 108. Similarly, we used data from 2006 instead of 2007 because it was more complete.

128. *See infra* tbl.6.

129. *See infra* tbl.6.

130. *See infra* tbl.6.

Table 6. Total United States Franchised Units by Type of Dispute Resolution Clause, 2000 & 2006 <sup>131</sup>		
	2000	2006
Arbitration Clause	57,401 (43.3%)	76,166 (46.0%)
Exclusive Forum Selection Clause	40,380 (30.5%)	64,690 (39.1%)
Nonexclusive Forum Selection Clause	5982 (4.5%)	7003 (4.2%)
No Dispute Resolution Clause	28,817 (21.7%)	17,545 (10.6%)

#### D. Are Franchisors Modifying Their Arbitration Clauses?

Alternatively, we consider the possibility that, instead of fleeing arbitration altogether, franchisors are modifying their arbitration clauses in response to their dissatisfaction with arbitration. This Part considers three types of changes that franchisors might make. First, in response to court decisions holding provisions in arbitration clauses unconscionable,<sup>132</sup> the franchisor might eliminate or modify provisions frequently challenged in court.<sup>133</sup> Second, the franchisor might eliminate or modify provisions that increase the cost of arbitration. Third, the franchisor might add or modify provisions to reduce the perceived risk of aberrational awards.<sup>134</sup>

This Part examines how, if at all, those franchisors that continue to include arbitration clauses in their contracts have changed their

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131. Our first choice as the data source for Table 6 was *Entrepreneur Magazine's Franchise 500* for 2000 and 2006. If the data was unavailable from that source, we used the nearest available years of the *Franchise 500*, *Bond's Franchise Guide*, or Item 10 of the Uniform Franchise Offering Circular for the franchisor, as most appropriate. We resolved any uncertainties in the data in the way that offered least support for the hypothesis examined.

132. See *supra* text accompanying notes 64-81.

133. The franchisor might modify the provisions because of the risk that the arbitration clause will be invalidated, because of the expense of litigating the issue in court, or because of costs to its reputation for fair dealing.

134. Another possibility, which we do not evaluate here, is that the franchisor might modify non-dispute resolution terms of the franchise agreement, such as the upfront investment required or the royalty charged the franchisee. See Heller & Lagarias, *supra* note 81, at 16 ("One suggestion is to draft the franchise agreement to provide the franchisor's home state as the forum for any arbitration in exchange for the franchisee paying a reduced initial franchise fee.")

arbitration clauses since 1999.<sup>135</sup> We begin with the same sample as above, but focus only on the twenty-eight franchisors that included arbitration clauses in their franchise agreements in both 1999 and 2007. We examine an array of provisions in those franchise arbitration clauses: provisions dealing with (1) the choice of arbitration provider; (2) arbitrator selection; (3) discovery; (4) judicial review of awards; (5) class arbitration; (6) location of arbitration proceedings; (7) arbitration costs; (8) time limits on claims; (9) punitive damages limitations; and (10) carve-outs (that is, exceptions from arbitration).<sup>136</sup>

*Choice of Arbitration Provider.* Some franchisors and other drafting parties have expressed dissatisfaction with the rules and costs of the AAA.<sup>137</sup> The rules specified in the arbitration clause address a wide range of issues, although in many cases the parties remain able to modify the rules in their arbitration clause.<sup>138</sup> In addition, by specifying that the AAA is to administer the arbitration proceeding, the parties are agreeing to pay the AAA to provide administrative services. Those costs depend on the amount in dispute, but can be substantial for large claims.<sup>139</sup>

Table 7 summarizes the choice of arbitration provider in the clauses studied. In 1999, the choice was unanimous: All twenty-eight franchisors in the sample specified the AAA in their arbitration

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135. In this context, and unlike the use of arbitration clauses as discussed *supra* text accompanying note 121, the aggregate data do not mask offsetting changes in the use of the provisions, and so we report only the aggregate numbers.

136. The results presented in the text are based on the provisions of the franchise agreements attached to the franchisor's disclosure documents. In addition, franchise agreements commonly contain state-specific addenda, which modify the provisions of the franchise agreements for franchisees located in a particular state. All of the state-specific addenda in the sample are for franchisees located in states with franchise registration requirements, and all appear to be changes in response to regulatory action rather than any court decision. Some of the addenda modify provisions of the dispute resolution clause, most commonly to require arbitration to take place in the franchisee's home state, but very rarely to override a waiver of punitive damages, a time limit on bringing a claim, or a cost-shifting provision. *See, e.g.*, North Dakota Securities Department, Registration Requirements, Franchise, <http://www.ndsecurities.com/registrations/> (select "Registration of Franchises") (last visited Dec. 12, 2008).

137. Marek, *supra* note 7, at 9 ("There are a lot of people who are not happy with the process of the American Arbitration Association or its rules." (quoting Rupert Barkoff)); Dunham & Lockerby, *supra* note 10, at 12 ("The AAA is a venerable organization, but its administrative fees can be high, and as a result of a recent consolidation of its offices, the quality of the administrative staff (including its knowledge of the skills and experience of potential arbitrators) can leave something to be desired. Most important, standard AAA arbitration pools vary widely in caliber.").

138. W. Mark C. Weidemaier, *The Arbitration Clause in Context: How Contract Terms Do (and Do Not) Define the Process*, 40 CREIGHTON L. REV. 655, 667 (2007).

139. Drahozal, *supra* note 13, at 736.

clauses.<sup>140</sup> In 2007, only twenty-four of twenty-eight (85.7%) specified the AAA.<sup>141</sup> One clause specified JAMS (originally Judicial Arbitration and Mediation Services), and three others set out a list of possible choices.<sup>142</sup> The list typically included the AAA, but permitted the parties (or the franchisor) to choose an alternative.

	1999	2007
AAA	28 (100%)	24 (85.7%)
JAMS	0 (0.0%)	1 (3.6%)
Choice Among Providers	0 (0.0%)	3 (10.7%)

Thus, since 1999 there has been some shift away from the AAA, although the substantial majority of franchise arbitration clauses still choose the AAA. Interestingly, while JAMS was the most commonly specified alternative provider (albeit only in two clauses), the other providers specified (as possible choices among various alternatives) were United States Arbitration and Mediation Midwest, Inc. (located in St. Louis, Missouri),<sup>143</sup> and the American Dispute Resolution Center (located in Connecticut),<sup>144</sup> two lesser known arbitration providers.

*Arbitrator Selection.* A neutral decisionmaker is central to the fairness of an arbitration proceeding (and to the enforceability of an

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140. Actually, one arbitration clause in 1999 did not provide for the AAA to administer the arbitration, instead providing that the arbitration be conducted “under the then-prevailing commercial arbitration rules of a recognized independent alternate dispute resolution service to be selected by Franchisor such as the American Arbitration Association, JAMS/Endispute or United States Mediation and Arbitration.” GNC Franchising, Inc., Agreement ¶ XXVI(C), at 42 (1999) (on file with the Hofstra Law Review). Because GNC no longer includes an arbitration clause in its franchise agreement (the GNC franchise agreement now contains an exclusive forum selection clause), GNC is not included in this sample.

141. *See infra* tbl.7.

142. *See infra* tbl.7.

143. Medicine Shoppe/Medicap Pharmacy, Franchise License Agreement ¶ XIV(D)(01), at 29 (2007) (on file with the Hofstra Law Review).

144. Doctor’s Assocs., Inc., Franchise Agreement ¶ 10(a), at 11 (2007) (on file with the Hofstra Law Review).

arbitration clause).<sup>145</sup> Among the 1999 franchise agreements, only one arbitration clause included an arbitrator selection procedure that was potentially problematic. The Schlotzsky's, Inc. arbitration clause required all arbitrators to be employed (within the preceding twelve months) in a "Qualified Food Service Position," which it defined as a "Corporate Officer or Area Supervisor (or equivalent) for a multi-unit, quick service (including fast food) restaurant or chain (exclusive of drive-in and chains specializing in chicken), having annual system wide gross sales in excess of Two Hundred Million Dollars (\$200,000,000.00)."<sup>146</sup> By limiting the pool of arbitrators essentially to corporate officials of large fast-food companies, the Schlotzsky's, Inc. clause was subject to legal challenge on unconscionability and other grounds. By 2007, the Schlotzsky's, Ltd. clause no longer contained the arbitrator qualification provision, instead merely providing that any dispute was to be resolved by a "single arbitrator."<sup>147</sup> Accordingly, none of the 2007 clauses contains a qualification provision<sup>148</sup> that raises any question about the neutrality of the decisionmaker.<sup>149</sup>

The number of arbitrators (either one or three) obviously affects the cost of the process. The parties can hold down the cost of arbitration by specifying a sole arbitrator in the arbitration clause.<sup>150</sup> Conversely, having a dispute resolved by a sole arbitrator may increase the risk of an aberrational award, so if the parties are willing to pay the extra cost of three arbitrators, they may be able to reduce that risk.<sup>151</sup> Thus, in

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145. Indeed, some courts have held that without a neutral decisionmaker, the process is not even arbitration, and the clause cannot be enforced under the governing arbitration statute. *E.g.*, *Cheng-Canindin v. Renaissance Hotel Assocs.*, 57 Cal. Rptr. 2d 867, 873 (Ct. App. 1996).

146. Schlotzsky's, Inc., Franchise Agreement ¶ 17.4(b)(iii), at 48 (1999) (on file with the Hofstra Law Review).

147. Schlotzsky's, Ltd., Franchise Agreement ¶ 21(B), at 31 (2007) (on file with the Hofstra Law Review). Schlotzsky's corporate name change reflects a series of acquisitions following its 2004 Chapter 11 filing. *See* Mary Alice Kaspar, *Schlotzsky's Next Move*, AUSTIN BUS. J., Sept. 23, 2005, available at <http://austin.bizjournals.com/austin/stories/2005/09/26/story2.html>.

148. Indeed, only three of the clauses in 2007 specify any qualification for the arbitrator or arbitrators, in all three cases requiring that the arbitrator be experienced in franchise law.

149. Of course, some have asserted that AAA's role in arbitrator selection results in bias because of the AAA's economic interest in having businesses continue to list it in their arbitration clauses. *See* Letter from Gerald A. Marks to Secretary, Fed. Trade Comm'n, available at <http://www.ftc.gov/os/comments/franrulestaffrpt/OL-100020.pdf> (commenting on the FTC Franchise Rule Staff Report and asserting that a "panel of neutrals [to resolve franchise disputes] are created and pre-selected by the AAA which has receive[d] significant money and assignments from [franchisors]").

150. Dunham & Lockerby, *supra* note 10, at 11.

151. Buttrick et al., *supra* note 8, at 21; Dunham & Lockerby, *supra* note 10, at 12. That is, unless deliberations move the panel of three arbitrators toward an extreme position. *See* David Schkade et al., *Deliberating About Dollars: The Severity Shift*, 100 COLUM. L. REV. 1139, 1153



choosing the number of arbitrators, the drafting party faces a possible tradeoff between the cost and riskiness of arbitration.

	1999	2007
One Arbitrator	6 (21.4%)	13 (46.4%)
Three Arbitrators	8 (28.6%)	4 (14.3%)
No Number Specified	14 (50.0%)	11 (39.3%)

As Table 8 indicates, franchisors increasingly have resolved this tradeoff in favor of holding down costs. Since 1999, the percentage of arbitration clauses specifying a sole arbitrator has more than doubled, with almost half (46.4%) of the clauses in 2007 so requiring.<sup>152</sup> Meanwhile, the percentage of clauses requiring three arbitrators has declined from 28.6% (eight of twenty-eight) in 1999 to 14.3% (four of twenty-eight) in 2007.<sup>153</sup> The results suggest that franchisors are more concerned about arbitration costs than about the risk of aberrational awards.<sup>154</sup>

*Discovery.* Discovery can be a major source of the cost of litigation. By comparison, limited discovery traditionally has been “one of the hallmarks of American commercial arbitration.”<sup>155</sup> But one of the complaints about arbitration is that discovery is increasing, along with the associated costs. One way a drafting party might respond to increased discovery costs in arbitration is by including a limitation on discovery in its franchise agreement. Conversely, limited discovery may reduce the accuracy of the dispute resolution process, possibly resulting in more erroneous awards.

Only a few franchise arbitration clauses include provisions addressing discovery, and those provisions did not change significantly

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(2000) (finding that mock jury panels are more likely than individual mock jurors to give higher monetary judgments in civil cases).

152. *See supra* tbl.8.

153. *See supra* tbl.8.

154. A possible alternative interpretation of these data is that franchisor fears of aberrational awards have proved unwarranted so that they now are willing to provide for one arbitrator instead of three to resolve any dispute. On this view, there might not be a tradeoff between cost and the risk of an aberrational award.

155. IAN R. MACNEIL ET AL., FEDERAL ARBITRATION LAW § 34.1 (Supp. 1999).

between 1999 and 2007. Four of the twenty-eight clauses (14.3%) both years imposed some limitation on discovery, although the limitations differed in detail.<sup>156</sup> Interestingly, in both years, two clauses (7.1%) provided for discovery in arbitration to the extent permitted by the Federal Rules of Civil Procedure, a significant expansion of discovery beyond that usual in arbitration.<sup>157</sup> Overall, then, the clauses reveal no change, either in response to court unconscionability decisions or concerns about the cost or accuracy of arbitration.

	1999	2007
Limiting Discovery	4 (14.3%)	4 (14.3%)
Providing for Discovery to the Extent Permitted by the Federal Rules of Civil Procedure	2 (7.1%)	2 (7.1%)
No Provision	22 (78.6%)	22 (78.6%)

*Judicial Review of Awards.* One commonly cited advantage of arbitration is that it avoids delays that result from potentially lengthy appeals.<sup>158</sup> Conversely, the lack of court review is also cited as a disadvantage of arbitration, because there is little a party can do if the arbitrator makes an aberrational award.<sup>159</sup> Limited court review thus is another characteristic of arbitration that highlights the possible tradeoff between cost savings and control of arbitral decisions. To the extent parties have become more sensitive either to cost or to the risk of aberrational decisions, one might see such perceptions reflected in changes in provisions dealing with court review of arbitral awards.

However, as Table 10 shows, the number of clauses that included provisions dealing with judicial review is unchanged between 1999 and 2007—only three of twenty-eight clauses (10.7%) contained such a provision in either year.<sup>160</sup> In both years, two clauses provided for de

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156. See *infra* tbl.9.

157. See *infra* tbl.9.

158. Lipsky & Seeber, *supra* note 37, at 17.

159. *Id.* at 26.

160. See *infra* tbl.10.

novo review of arbitral awards exceeding specified dollar amounts.<sup>161</sup> In 1999, one clause required arbitrators to follow the law, a provision that has the effect of permitting de novo review of arbitral legal rulings.<sup>162</sup> By comparison, in 2007, no clause required the arbitrators to follow the law, but one clause purported to limit court review to the grounds specified in section 10 of the FAA.<sup>163</sup> Presumably, the clause seeks to preclude courts from reviewing awards for manifest disregard of the law and other nonstatutory grounds.<sup>164</sup>

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161. See *infra* tbl.10.

162. See *infra* tbl.10; see also Christopher R. Drahozal, *Contracting Around RUAA: Default Rules, Mandatory Rules, and Judicial Review of Arbitral Awards*, 3 PEPP. DISP. RESOL. L.J. 419, 431-33 (2003).

163. See *infra* tbl.10.

164. See *Wilko v. Swan*, 346 U.S. 427, 436 (1953) (dictum) (“In unrestricted submissions . . . the interpretations of law by the arbitrators *in contrast to manifest disregard* are not subject, in the federal courts, to judicial review for error in interpretation.” (emphasis added)). *But see* *Birmingham News Co. v. Horn*, 901 So. 2d 27, 48-49 (Ala. 2004) (finding that every federal circuit recognizes “manifest disregard of the law” as a basis for vacating arbitration awards). In *Hall Street Associates v. Mattel, Inc.*, the Supreme Court cast doubt on the availability of non-statutory grounds like manifest disregard by stating that section 10 of the FAA sets out the exclusive grounds for vacating awards. 128 S. Ct. 1396, 1405-06 (2008); see also *Ramos-Santiago v. United Parcel Serv.*, 524 F.3d 120, 124 n.3 (1st Cir. 2008) (dicta) (describing *Hall Street* as deciding “that manifest disregard of the law is not a valid ground for vacating or modifying an arbitral award in cases brought under the Federal Arbitration Act”); *Robert Lewis Rosen Assocs. v. Webb*, 566 F. Supp. 2d 228, 233 (S.D.N.Y. 2008) (“[I]n *Hall Street*, the Court finds that the manifest disregard of the law standard is no longer good law.”); *Prime Therapeutics L.L.C. v. Omnicare, Inc.*, 555 F. Supp. 2d 993, 999 (D. Minn. 2008) (stating that after *Hall Street*, courts “need not address . . . extra-statutory grounds for vacating the arbitration award—that the arbitrator ignored the plain and unambiguous language of the agreement and that the arbitrator’s decision was in manifest disregard of the law”).

Table 10. Judicial Review Provisions		
	1999	2007
Limiting Arbitrator Authority to Make Errors of Law	1 (3.6%)	0 (0.0%)
De Novo Review	2 (7.1%)	2 (7.1%)
Excluding Review on Nonstatutory Grounds	0 (0.0%)	1 (3.6%)
None	25 (89.3%)	25 (89.3%)

*Class Arbitration.* One important change in the arbitration process since 1999 has been the growth of class arbitration. Although class arbitration has been around at least since the 1980s,<sup>165</sup> its use increased dramatically after the Supreme Court's decision in *Green Tree Financial Corp. v. Bazzle*,<sup>166</sup> as shown by the growth in the AAA's class arbitration docket since that time.<sup>167</sup>

If one of the reasons parties use arbitration clauses is to avoid aggregate relief, one would expect them to respond to the growth of class arbitration by inserting class arbitration waivers in their arbitration clauses. Indeed, Justice Stevens so predicted during oral argument in *Bazzle*.<sup>168</sup> At the same time, parties that add a class arbitration waiver face the risk that a court will hold the provision unconscionable, as an increasing number of courts have done.<sup>169</sup> If so, and if the court finds the class arbitration waiver severable, the case will proceed to class

165. *Keating v. Superior Court*, 645 P.2d 1192, 1209-10 (Cal. 1982), *rev'd on other grounds sub nom.*, *Southland Corp. v. Keating*, 465 U.S. 1 (1984). See generally Jean R. Sternlight, *As Mandatory Binding Arbitration Meets the Class Action, Will the Class Action Survive?*, 42 WM. & MARY L. REV. 1 (2000) (discussing early class arbitration proceedings).

166. 539 U.S. 444 (2003).

167. Drahozal, *supra* note 31, at 836-37. Following *Bazzle*, the AAA issued its Supplementary Rules for Class Arbitrations. SUPPLEMENTARY RULES FOR CLASS ARBITRATION (effective Oct. 8, 2003), available at <http://www.adr.org/sp.asp?id=21936>. JAMS, another arbitration provider, issued its Class Action Procedures in February 2005. JAMS CLASS ACTION PROCEDURES (2005), available at [http://www.jamsadr.com/rules/class\\_action.asp](http://www.jamsadr.com/rules/class_action.asp).

168. Transcript of Oral Argument at 55, *Green Tree Fin. Corp.*, 539 U.S. 444 (No. 02-634), available at [www.supremecourtus.gov/oral\\_arguments/argument\\_transcripts/02-634.pdf](http://www.supremecourtus.gov/oral_arguments/argument_transcripts/02-634.pdf) ("Does this case have any real future significance, because isn't it fairly clear that all the arbitration agreements in the future will prohibit class actions?").

169. See *supra* text accompanying note 69.

arbitration anyway. If the court finds the class arbitration waiver not to be severable, the case presumably will proceed as a putative class action in court.<sup>170</sup>

As shown in Table 11, Justice Stevens's prediction largely has been borne out in the franchise setting: The number of franchisors that included class arbitration waivers in their arbitration clauses increased significantly from 1999 to 2007, from fifteen of twenty-eight (or 53.6%) to twenty-two of twenty-eight (or 78.6%).<sup>171</sup> Most of the class arbitration waivers simply contain language waiving class relief in arbitration. A handful of clauses achieve the same result either by requiring arbitration to proceed on an individual basis only (two of twenty-eight, or 7.1%, in 1999, and one of twenty-eight, or 3.6%, in 2007) or by precluding joinder or consolidation (two of twenty-eight, or 7.1%, in both 1999 and 2007).<sup>172</sup>

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170. See Christopher R. Drahozal & Quentin R. Wittrock, *Franchising, Arbitration, and the Future of the Class Action*, 3 ENTREPRENEURIAL BUS. L.J. (forthcoming 2008) (manuscript at 17-20, on file with the Hofstra Law Review).

171. See *infra* tbl.11.

172. See *infra* tbl.11.

Table 11. Class Arbitration and Class Action Provisions		
	1999	2007
Class Arbitration Waiver	15 (53.6%)	22 (78.6%)
Waives Class Arbitration	11 (39.3%)	15 (53.6%)
Waives Class Arbitration; Non-severability Provision	0 (0%)	3 (10.7%)
Waives Class Arbitration; Option Regarding Provider	0 (0%)	1 (3.6%)
No Joinder or Consolidation	2 (7.1%)	2 (7.1%)
Individual Proceedings Only	2 (7.1%)	1 (3.6%)
Permits Class Arbitration for Specified Type of Claim; Otherwise Waives Class Arbitration	2 (7.1%)	2 (7.1%)
Permits Consolidation and Class Actions in Court, but Waives Class Arbitration	1 (3.6%)	1 (3.6%)
None	10 (35.7%)	3 (10.7%)

Several of the class arbitration waivers in 2007 franchise agreements were more elaborate. One (of twenty-eight, or 3.6%) provided that if the arbitration provider refused to enforce the class arbitration waiver, a different provider would be used.<sup>173</sup> Three others (three of twenty-eight, or 10.7%) addressed the severability issue directly, and provided that in the event the class arbitration waiver is held unenforceable, the entire arbitration clause is invalid.<sup>174</sup> Without such a clause, as noted above, a court might sever an invalid class arbitration waiver and order the case to proceed to arbitration on a class basis. With such a clause, the case likely will proceed in court as a putative class action. None of the 1999 arbitration clauses included such a provision.

Non-severability provisions could be characterized as a form of flight from arbitration, albeit only in the limited number of cases in which the provisions are implicated. By including a non-severability provision in their arbitration clause, parties are indicating that they

173. *See supra* tbl.11.

174. *See supra* tbl.11.

prefer class actions in court over class arbitrations. On the other hand, attempts to avoid class arbitration arguably are not a flight from arbitration, at least as it was traditionally conducted, but rather a flight from a new form of dispute resolution that largely did not exist until recent years.

Interestingly, two of the clauses (two of twenty-eight, or 7.1%, both in 1999 and 2007) permitted class arbitration, but only of claims by franchisees against the franchisor for misappropriation of funds.<sup>175</sup> One other clause waived class arbitration but permitted both (1) consolidation of related cases in arbitration and (2) claims subject to a class action in court to proceed in court.<sup>176</sup>

*Location of Arbitration Proceeding.* Arbitration clauses in franchise agreements commonly address the location of the arbitration proceeding. Some courts have held location provisions unconscionable when they specify a location (such as the home office of the franchisor) that is inconvenient for the non-drafting party.<sup>177</sup>

As Table 12 illustrates, there has been no change in the percentage of franchise agreements providing for arbitration to take place at the franchisor's home. In both 1999 and 2007, 82.1% (twenty-three of twenty-eight) of the franchise arbitration clauses specified the franchisor's home as the place of arbitration.<sup>178</sup> In both years, only one clause specified the franchisee's home, one specified the respondent's home, one specified a neutral location, and one gave the choice to the franchisor.<sup>179</sup>

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175. See *supra* tbl.11.

176. In Table 11, we did not classify this clause as including a class arbitration waiver because it effectively excludes class actions from arbitration altogether.

177. See cases cited *supra* note 70.

178. See *infra* tbl.12.

179. See *infra* tbl.12.

Table 12. Location of Arbitration Proceeding		
	1999	2007
Franchisor's Home	23 (82.1%)	23 (82.1%)
Option for Franchisor	1 (3.6%)	1 (3.6%)
Franchisee's Home	1 (3.6%)	1 (3.6%)
Neutral Location	1 (3.6%)	1 (3.6%)
Respondent's Home	1 (3.6%)	1 (3.6%)
No Location	1 (3.6%)	1 (3.6%)

*Arbitration Costs.* Arbitration differs from litigation in that upfront costs can be higher: Parties in arbitration typically must put down a deposit to cover arbitrator fees and any administrative costs. By comparison, the only cost to file suit in court is a (relatively) small filing fee.<sup>180</sup> These upfront costs of arbitration have provided a common basis for parties to challenge the enforceability of arbitration clauses—by asserting that arbitration costs prevented the claimant from vindicating his or her statutory rights or rendered the arbitration clause unconscionable.<sup>181</sup> In addition, the parties themselves may allocate arbitration costs (including attorneys' fees) in their arbitration agreements or otherwise in their contracts. Depending on how they are drafted, these provisions may reduce the risk of court challenge (such as by providing that the drafting party agrees to bear the costs of arbitration, for example) or may themselves be subject to challenge as unconscionable.<sup>182</sup>

As Table 13 shows, franchise agreements include a variety of provisions dealing with the allocation of costs, which have changed little

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180. Drahozal, *supra* note 71, at 736-42.

181. *Id.* at 742-56; *see also* Green Tree Fin. Corp.—Ala. v. Randolph, 531 U.S. 79, 90 (2000) (dictum) (“It may well be that the existence of large arbitration costs could preclude a litigant . . . from effectively vindicating her federal statutory rights in the arbitral forum.”).

182. *See supra* text accompanying notes 71.



between 1999 and 2007.<sup>183</sup> The number of clauses adopting the British-rule—that the prevailing party can recover its attorneys’ fees—is unchanged from 1999 to 2007,<sup>184</sup> although the number of clauses providing the franchisor (but not the franchisee) that remedy increased, albeit only slightly. Only one clause provided for the franchisor to assist the franchisee with arbitration costs, and one other clause reserved to the franchisor the right to do so.<sup>185</sup>

	1999	2007
Bear Own Costs with Exceptions	6 (21.4%)	6 (21.4%)
Prevailing Party	11 (39.3%)	11 (39.3%)
Franchisor as Prevailing Party	3 (10.7%)	5 (17.9%)
Share Arbitrators’ Fees	1 (3.6%)	1 (3.6%)
Cost Assistance by Franchisor	0 (0.0%)	1 (3.6%)
No Provision	7 (25.0%)	4 (14.3%)

*Time Limits on Claims.* Provisions setting a time limit for bringing a claim (typically shorter than the statute of limitations) also have been held unconscionable by some courts.<sup>186</sup> More franchisors included such provisions in their arbitration clauses in 2007 than in 1999.<sup>187</sup> In 1999, 42.9% of the clauses included some time limit for bringing claims; by 2007, 60.7% of the clauses included such a provision.<sup>188</sup> Accordingly, the changes in time limit provisions provide no evidence that franchisors

183. See *infra* tbl.13. Cost allocation provisions appear in many different parts of the franchise agreement, not just in the arbitration clause. Thus, the numbers shown in Table 13 may understate the frequency of such provisions.

184. See *infra* tbl.13.

185. See *infra* tbl.13.

186. See *supra* text accompanying notes 66, 72.

187. See *infra* tbl.14.

188. Several of the clauses specify alternative time limits—one year to two years (two in 2007); six months to one year (one in 1999; one in 2007); one year to eighteen months (one in 2007)—typically one that begins to run when the dispute arises and the other when the claimant has knowledge of the claim.

are responding to court unconscionability decisions by modifying their arbitration clauses.

	1999	2007
Six Months to One Year	6 (21.4%)	9 (32.1%)
With Exceptions	2 (7.1%)	4 (14.3%)
Eighteen Months to Two Years	1 (3.6%)	2 (7.1%)
With Exceptions	2 (7.1%)	2 (7.1%)
Three Years	1 (3.6%)	2 (7.1%)
No Provision	16 (57.1%)	9 (32.1%)

*Punitive Damages Limitations.* An important reason some drafting parties include arbitration clauses is to reduce the risk of punitive damages awards.<sup>189</sup> But a number of courts have held punitive damages waivers unconscionable, in some cases invalidating the entire arbitration clause as well.<sup>190</sup>

Although the percentage of franchise arbitration clauses with waivers of all recovery of punitive damages declined somewhat (from 53.6% to 46.4%) from 1999 to 2007,<sup>191</sup> the percentage of clauses with some waiver of punitive damages increased (from 64.3% to 75.0%).<sup>192</sup> The reason, as Table 15 shows, is a sizable increase in the number of clauses waiving some but not all recovery of punitive damages. In most cases, the exceptions appear one-sided, permitting the recovery of punitive damages for claims that typically would be asserted by the franchisor against the franchisee, but not vice versa.

189. Drahozal & Hylton, *supra* note 6, at 574.

190. *See supra* note 73 and accompanying text.

191. *See infra* tbl.15.

192. *See infra* tbl.15.

Table 15. Restrictions on Punitive Damages		
	1999	2007
Waives Punitive Damages	15 (53.6%)	13 (46.4%)
Waives Punitive Damages with Exceptions	3 (10.7%)	8 (28.6%)
Franchisee Waives Punitive Damages	1 (3.6%)	0 (0%)
Waiver of Punitive Damages with Severability Provision	0 (0%)	1 (3.6%)
Arbitrator Lacks Authority to Award Punitive Damages	2 (7.1%)	2 (7.1%)
No Provision	7 (25.0%)	4 (14.3%)

*Carve-Outs (that is, Exceptions to Arbitration).* Virtually every arbitration clause in the sample excluded (carved out) some disputes or claims from arbitration.<sup>193</sup> Such carve-outs have been controversial. On the one hand, carve-outs make sense given that the benefits and costs of arbitration vary depending on the type of dispute or remedy.<sup>194</sup> On the other hand, several courts have held arbitration clauses unenforceable (on either unconscionability or other grounds) because of carve-outs that allegedly permitted the drafting party but not the non-drafting party to go to court.<sup>195</sup>

Table 16 lists the most common carve-outs from franchise arbitration clauses in the sample. The percentage of clauses containing each type of carve-out has either stayed the same or increased slightly from 1999 to 2007.<sup>196</sup> For example, the most common carve-out is for trademark disputes, which appeared in 67.9% of the franchise arbitration clauses in 1999 and 71.4% of the clauses in 2007.<sup>197</sup> Carve-outs of

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193. Some franchisors lease or sublease the franchised premises to franchisees, using leases that do not contain arbitration clauses. Such agreements may effectively exclude claims for repossession of real property from arbitration without including language to that effect in the arbitration clause. As a result, Table 16 may understate the number of exceptions in arbitration clauses in the sample. Of course, sometimes franchisors expressly exclude disputes arising out of subleases from the arbitration clause in the franchise agreement.

194. See *supra* Part II.

195. See, e.g., *E-Z Cash Advance, Inc. v. Harris*, 60 S.W.3d 436, 442 (Ark. 2001); *Armendariz v. Found. Health Psychare Servs., Inc.*, 6 P.3d 669, 694 (Cal. 2000).

196. See *infra* tbl.16.

197. See *infra* tbl.16.

claims for provisional remedies and injunctive relief (which also are relevant for trademark disputes, although not limited to such disputes) also were more frequent, although, again, not dramatically so.<sup>198</sup>

Table 16. Common Exceptions to Arbitration (“Carve-Outs”)		
	1999	2007
Trademark Disputes	19 (67.9%)	20 (71.4%)
Provisional Remedies	12 (42.9%)	14 (50.0%)
Injunctive Relief	11 (39.3%)	14 (50.0%)
Money Due	8 (28.6%)	10 (35.7%)
Covenants Not to Compete	7 (25.0%)	8 (28.6%)
Immediate Termination of Franchise	7 (25.0%)	7 (25.0%)
Confidential Information	3 (10.7%)	6 (21.4%)
Repossession of Property	4 (14.3%)	4 (14.3%)

The slight increase in the frequency of carve-outs reflects some degree of flight from arbitration (although a relatively minor one). The risk of court invalidation for lack of mutuality or unconscionability seems not to have discouraged franchisors from excluding certain disputes or remedies from their arbitration clauses.

## V. CONCLUSION

Subject to the limitations of our dataset, we find little evidence that franchisors in the aggregate are fleeing arbitration. The percentage of franchisors that include arbitration clauses in their franchise agreements is virtually the same in 2007 as it was in 1999, although some franchisors have stopped using arbitration clauses while others have started. Likewise, there is no indication that franchisees are fleeing arbitration by avoiding franchisors that use arbitration clauses. We do

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198. See *infra* tbl.16.

find a slight increase in the use of carve-outs, which is a limited form of flight. Moreover, the increased use of non-severability provisions (none in 1999; three of twenty-eight, or 10.7% in 2007),<sup>199</sup> which result in the invalidation of the arbitration clause in the event the class arbitration waiver in the clause is held invalid, might also be a form of flight, albeit again in only a limited number of cases.

As for other terms in arbitration clauses, the most significant change has been the substantial increase in class arbitration waivers (from 50% to over 80% of clauses).<sup>200</sup> Other common changes, such as providing for a sole arbitrator instead of a panel of three arbitrators, appear designed to reduce arbitration costs. Indeed, when facing a choice between holding down costs and reducing the risk of aberrational awards, parties that modified clauses typically made changes that would hold down costs.

Finally, we find almost no modifications to arbitration clauses in response to the risk of court invalidation (the non-severability provisions being the most notable exception). Franchisors have not reduced their use of any of the provisions that some courts have held unconscionable. It may be that parties have not had sufficient time to respond to cases like *Nagrampa* (the en banc opinion was not issued until December 4, 2006, while the data was collected in mid-2007).<sup>201</sup> Or it may be that some combination of switching costs,<sup>202</sup> a bias in favor of the status quo,<sup>203</sup> or simply inertia are the explanation. But so far, at any rate, court decisions have had almost no effect on the terms of franchise arbitration clauses.

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199. See *supra* tbl.11.

200. See *supra* text accompanying note 21.

201. *Nagrampa v. MailCoups, Inc.*, 469 F.3d 1257 (9th Cir. 2006) (en banc).

202. Marcel Kahan & Michael Klausner, *Standardization and Innovation in Corporate Contracting* (or “*The Economics of Boilerplate*”), 83 VA. L. REV. 713, 727-29 (1997) (“Switching costs may create pressure for a firm to avoid adopting terms in a new contract that deviate from those in its existing contracts.”); W. Mark C. Weidemaier, *Disputing Boilerplate*, 82 TEMP. L. REV. (forthcoming Spring, 2008) (manuscript at 9-11, on file with authors).

203. Cf. Russell Korobkin, *The Status Quo Bias and Contract Default Rules*, 83 CORNELL L. REV. 608, 612 (1998) (“[C]ontracting parties view default terms as part of the status quo, and they prefer the status quo to alternative states, all other things equal.”).