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## Restrictions on Forum-Selection Clauses in Franchise Agreements and the Federal Arbitration Act: Is State Law Preempted?

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## I. INTRODUCTION

The use of forum-selection clauses in contracts continues to increase. Emboldened by the Supreme Court's endorsement of forum-selection clauses,<sup>1</sup> large companies now frequently use these clauses in a variety of contracts. Contracting parties use these clauses in part to ensure that the parties can resolve any dispute in a convenient forum. Often, however, a party inserts a forum-selection clause to limit liability by increasing the barriers to litigation or arbitration.<sup>2</sup> Typically, the party inserting the forum-selection clause has superior bargaining power and inserts into the contract a clause designating a forum remote to the other party, where any dispute over the contract will be heard. In this scenario, the other party to the contract, if seeking redress for a breach of the contract, must travel to a distant and unfamiliar jurisdiction to have the claim heard, often before the opposing party's "home court." When the party seeking redress is unsophisticated and has no wealth of resources, the costs associated with bringing a suit can be prohibitive.<sup>3</sup> Thus, the party inserting the forum-selection clause is less likely to be sued or held liable for a breach.

In recent years, businesses have begun using a special kind of forum-selection clause: an arbitration clause which provides that any dispute will be resolved in binding arbitration.<sup>4</sup> Sometimes parties use these clauses to ensure that an expert will decide the dispute or to avoid the cost and inconvenience of litigation. Again, however, parties often use arbitration clauses to force a weaker party to seek redress in a remote, unfamiliar forum.

Forum-selection clauses and arbitration clauses are common in franchise contracts.<sup>5</sup> In the typical franchise contract, the franchisor

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1. See *infra* Part III.A for a discussion of the Supreme Court's treatment of forum-selection clauses under federal law.

2. See Edward A. Purcell, Jr., *Geography as a Litigation Weapon: Consumers, Forum-Selection Clauses, and the Rehnquist Court*, 40 UCLA L. REV. 423, 445-449 (1992) (discussing in detail the hardships imposed on would-be plaintiffs by forum-selection clauses).

3. See *id.*

4. Arbitration agreements are generally regarded as a kind of forum-selection clause because they indicate the forum in which the dispute is to be heard. See *Scherk v. Alberto-Culver Co.*, 417 U.S. 506, 519 (1974) (characterizing an arbitration agreement as "a specialized kind of forum-selection clause").

5. See Benjamin A. Levin & Richard S. Morrison, *Kubis and the Changing Landscape of Forum Selection Clauses*, 16 FRANCHISE L.J. 97, 115-16 (1997) (summarizing Supreme Court treatment of the Federal Arbitration Act and predicting the future controversy of "the enforceability of arbitration provisions requiring... a designated site"). A franchise agreement is generally defined as "an agreement between a supplier of a product or service or an owner of a desired trademark or copyright (franchisor), and a reseller (franchisee) under which the franchi-

is a large, national corporation, represented by sophisticated legal counsel. The franchisee is an individual, often unsophisticated, and almost always unrepresented by legal counsel at the time of contracting. The contract is presented to the franchisee on a take-it-or-leave-it basis. If the franchisee objects to the terms the franchisor can usually find another willing franchisee. The contract is several pages long, with the arbitration/forum-selection clause hidden beneath boilerplate legalese.<sup>6</sup> These circumstances provide a great incentive for franchisors to use the forum-selection clause as a weapon to limit the franchisee's legal recourse. The franchisees, often unsophisticated and not represented by legal counsel, are likely not to read the clause or to understand fully its implications. Even if the franchisee does recognize the clause's significance, little or no opportunity to change it will exist.<sup>7</sup>

In response to this type of overreaching by franchisors, several states have adopted laws that require arbitration or litigation over a franchise contract to occur in the franchisee's home state and which void contractual provisions that provide otherwise.<sup>8</sup> These laws are often enacted as part of a state's franchise laws, which generally are designed to protect franchisees from unfair contracts and unfair treatment by franchisors who have superior bargaining power.<sup>9</sup> The statutes restricting forum-selection clauses are specifically aimed at protecting the franchisee from having to pursue redress of a breach of contract in a remote forum.<sup>10</sup> Many states have recently passed these laws (or have promulgated them in state courts), and commentators predict that this trend will continue.<sup>11</sup>

Arguably, however, these state laws cannot invalidate arbitration agreements because of the preemptive power of the Federal

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see agrees to sell the franchisor's product or service or to do business under the franchisor's name." BLACK'S LAW DICTIONARY 658 (6th ed. 1990). A common example of a franchise is the ownership of a single fast-food restaurant.

6. See Donald B. Brenner, *There is a Developing Trend Among Courts of Making Choice of Forum Clauses in Franchise Agreements Presumptively Invalid*, 102 COM. L.J. 94, 94-95 (1997) (discussing the imbalance of power in franchise agreements).

7. The American Franchise Association identifies arbitration agreements calling for arbitration in the franchisor's home state as among the most oppressive franchise agreement provisions. See *Franchise Agreement Arbitration Clauses Are Here to Stay . . . Or Are They?*, 7 WORLD ARB. & MEDIATION REP. 172, 173 (1996).

8. See *infra* Part III.B for a detailed discussion of these statutes and rules.

9. See *infra* Part III.B for a discussion of the legislative and judicial purposes behind these laws.

10. See *id.*

11. See Brenner, *supra* note 6, at 108-13; Levin & Morrison, *supra* note 5, at 97.

Arbitration Act ("FAA").<sup>12</sup> The Supreme Court has interpreted the FAA as establishing a national policy in favor of arbitration.<sup>13</sup> Any state law which undermines this policy, or which singles out arbitration agreements for suspect treatment, is in danger of FAA preemption. The FAA does not preempt state laws that apply general contract law to invalidate arbitration agreements.<sup>14</sup> In light of recent Supreme Court decisions, however, the breadth of this exception is uncertain.<sup>15</sup>

Considering several factors, including the increasing use of arbitration clauses selecting out-of-state forums in franchise contracts, the trend among states to hold this type of forum-selection clause invalid in franchise contracts, and the broad scope of preemptive power that the Supreme Court has given the FAA, the question of a state law's ability to invalidate a foreign state arbitration agreement stands to be an important, and hotly contested issue in the near future.<sup>16</sup> This Note argues that the FAA should not preempt state franchise laws which limit the use of forum-selection clauses in franchise contracts. First, Part II surveys the history of the FAA and its preemptive power over state law. Part III analyzes the law governing the validity of forum-selection clauses, including both the general law of forum-selection clauses and the specific limits some states place on them in franchise contract settings. Finally, Part IV examines the interplay between these two doctrines. This section argues that state laws which void forum-selection agreements do not hold arbitration clauses to a higher standard than other contracts and do not undermine the policy of the FAA. Instead, these state laws address the inherent unfairness in requiring individuals to seek redress in remote forums.<sup>17</sup> This focus is a legitimate application of state law that is outside the scope of the FAA.<sup>18</sup>

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12. 9 U.S.C. §§ 1-307 (1994).

13. See *infra* Part II (discussing the FAA's preemptive power).

14. See *Doctor's Assocs., Inc. v. Casarotto*, 517 U.S. 681 (1996).

15. See *infra* Part II.A.

16. See Levin & Morrison, *supra* note 5, at 115-16.

17. See *infra* Part IV.B.

18. See *infra* Part IV.

## II. PREEMPTIVE POWER OF THE FAA

As interpreted by the Supreme Court, the FAA has broad preemptive power over state laws that conflict with its text or policies.<sup>19</sup> Limits to the statute's preemptive powers exist, but have yet to be defined clearly. The Supreme Court has a long history of interpreting the FAA. Lower courts have applied the principles laid out by the Supreme Court to a variety of arbitration agreements. A handful of cases directly addresses whether the FAA preempts state laws limiting forum-selection.

### A. *The Supreme Court's Interpretation of the FAA*

Congress enacted the FAA in 1925 to overrule the existing common law that often invalidated arbitration agreements.<sup>20</sup> Section 2 of the FAA proclaims that in all contracts "involving commerce," an arbitration agreement "shall be valid, irrevocable, and enforceable, save upon such grounds as exist at law or in equity for the revocation of any contract."<sup>21</sup> In spite of its sweeping language, the FAA initially had little effect on the enforceability of arbitration agreements.<sup>22</sup> For years, many believed the FAA applied only in federal court.<sup>23</sup> As a result, state courts continued to apply anti-arbitration case law to invalidate arbitration agreements.<sup>24</sup> In 1967, the Supreme Court first held that the FAA was federal substantive law that Congress enacted under its Commerce Clause powers, and thus the Act applied to all cases involving interstate commerce.<sup>25</sup> Even after this case, it remained unclear how the FAA would interact with state laws governing arbitration.<sup>26</sup>

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19. See *infra* Part II.A for a discussion of the Supreme Court's broad interpretation of the FAA's preemptive power.

20. Prior to the FAA, courts usually considered arbitration agreements either void or voidable at the will of any party. The primary rationale for this rule was the puzzling claim that arbitration ousted the jurisdiction of courts, violating public policy. See Thomas A. Diamond, *Choice of Law Clauses and Their Preemptive Effect upon the Federal Arbitration Act: Reconciling the Supreme Court with Itself*, 39 ARIZ. L. REV. 35, 35-37 (1997).

21. 9 U.S.C. § 2 (1997).

22. See IAN R. MACNEIL, *AMERICAN ARBITRATION LAW: REFORMATION, NATIONALIZATION, INTERNATIONALIZATION* 122-33 (1992) (discussing the relative dearth of cases brought in early years after passage of the FAA).

23. See *id.*

24. See *id.* at 122-27 (stating that early commentators believed that provisions of the Act governed only federal courts).

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

26. In *Prima Paint*, no state law was at issue. See *id.*

In recent years, however, the FAA's preemptive power over state laws has been greatly expanded by a number of Supreme Court opinions. This new era for arbitration began in 1983 with *Moses H. Cone Memorial Hospital v. Mercury Construction Corp.*<sup>27</sup> In *Moses H. Cone* the Court held that the FAA had established a federal policy in favor of arbitration, and thus, in cases involving questions of arbitrability, all ambiguities regarding the scope and validity of an arbitration clause should be resolved in favor of arbitration.<sup>28</sup> The Court also strongly suggested that the FAA would apply equally in state and federal courts.<sup>29</sup>

In *Southland Corp. v. Keating*, the Court explicitly held that the FAA applied in both federal and state courts.<sup>30</sup> The Court also concluded that, under the Supremacy Clause,<sup>31</sup> the FAA preempted state statutes that invalidated arbitration agreements.<sup>32</sup> The Court did note that arbitration agreements must be part of a written contract "involving commerce" in order to fall under the FAA, and even when controlled by the FAA could still be "revoked upon 'grounds as exist at law or in equity for the revocation of any contract.'"<sup>33</sup> In the absence of either of these exceptions, however, the FAA applied and upheld arbitration agreements regardless of state law.<sup>34</sup>

The Court briefly halted its expansion of the FAA's reach in *Volt Information Sciences, Inc. v. Board of Trustees*.<sup>35</sup> In *Volt*, the Court held that the FAA did not preempt a state law that allowed a court to stay arbitration pending resolution of related litigation.<sup>36</sup> The Court noted that the FAA does not "reflect a congressional intent to occupy the entire field of arbitration."<sup>37</sup> The key question, according

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27. 460 U.S. 1 (1983).

28. *See id.* at 24-25.

29. *See id.* at 26-27.

30. *See* 465 U.S. 1, 12-13 (1984).

31. U.S. CONST. art. VI, cl. 2. The Supremacy Clause reads "[t]his Constitution, and the Laws of the United States . . . shall be the Supreme Law of the Land; and the Judges in every state shall be bound thereby."

32. *See Southland Corp.*, 465 U.S. at 16. In *Southland*, the statute held to be preempted was a California franchise law which voided any contractual provision that requires the franchisee to waive compliance with any state franchise law. The California Supreme Court construed this statute to require judicial consideration of claims brought under the state franchise laws. *See id.* at 5.

33. *Id.* at 10-11 (quoting section 2 of the FAA).

34. *See id.* at 11.

35. 489 U.S. 468 (1989).

36. *See id.* at 478.

37. *Id.* at 477-78. The law conflicted with the FAA because the FAA does not authorize a stay of arbitration.

to the Court, was whether the state law at issue would undermine the FAA's goals and policies; here, it did not.<sup>38</sup>

Following *Volt*, however, the Supreme Court has expanded the reach of the FAA in two ways: (1) application of the FAA to nearly all contracts, and (2) preemption of almost every conflicting state law that deals specifically with arbitration. In *Allied-Bruce Terminix Cos., Inc. v. Dobson*, the Court held that the requirement that the contract "involve commerce" in order to fall under the FAA meant merely that the FAA extended to the limits of Congress's legislative power under the Commerce Clause.<sup>39</sup> Given the broad reach of the Commerce Clause, this means that the FAA applies to virtually every contract that includes an arbitration agreement.<sup>40</sup> Thus, the Court essentially eliminated one limitation that the *Southland* Court placed on the FAA.

The most recent Supreme Court decision concerning FAA preemption, *Doctor's Associates v. Casarotto*, also recognized the FAA's broad preemptive power.<sup>41</sup> In *Casarotto*, the Court invalidated a Montana statute that required an arbitration clause be printed on the first page of the contract, in underlined capital letters.<sup>42</sup> The Court reaffirmed *Southland*, noting that "generally applicable contract defenses," such as fraud or unconscionability, may still invalidate arbitration agreements, but that courts and state legislatures may not single out arbitration agreements and hold them to a higher level of scrutiny.<sup>43</sup>

Thus, in the law's present state, the FAA has broad preemptive power. The statute applies to nearly all contracts under *Allied-Bruce*. It also preempts every state law that singles out arbitration agreements for "suspect status." Finally, the Court has held that the FAA embodies a federal policy favoring arbitration agree-

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38. *See id.* The Court found that the state law did not undermine the goals and policies of the FAA because the state statute merely provided another procedure for enforcing an arbitration agreement, and because the parties to the agreement agreed that state arbitration law would cover their agreement. *See id.* at 479. For a discussion of the parties' choice of law on FAA preemption, see generally Diamond, *supra* note 20; Michael A. Hanzman, *Arbitration Agreements: Analyzing Threshold Choice of Law and Arbitrability Questions: An Often Overlooked Task*, 70 FLA. B.J. 14 (1996).

39. 513 U.S. 265, 273-74 (1995).

40. For example, the contract in *Allied-Bruce*, to which the FAA was ruled applicable, was a "Termite Protection Plan" between a homeowner and a local termite exterminator in Alabama. *Id.* at 837.

41. 517 U.S. 681, 688 (1996).

42. *See id.* at 689.

43. *See id.* at 688.



ments where "all doubts are resolved in favor of arbitration."<sup>44</sup> Notwithstanding the Court's comments in *Volt*, the FAA apparently has preempted the field of arbitration law.<sup>45</sup>

The Supreme Court has yet to decide, however, whether the FAA preempts state laws that, as applied, invalidate arbitration agreements but are also applicable to contract clauses other than arbitration clauses. A notable example of this type of law is a law that restricts the validity of a forum-selection clause. Lower courts have touched on this issue, but are far from resolving it.

### B. Lower Courts' Treatment of FAA Preemption

Lower courts have distinguished between laws that violate the FAA and are preempted, and laws that are merely "general contract law" and thus outside the preemptive scope of the FAA.<sup>46</sup> These decisions reinforce the principle that laws which "single out" arbitration agreements must give way to the FAA.<sup>47</sup> These cases, however, also provide strong support for the proposition that courts can use contract law principles to reject an arbitration agreement as unconscionable without violating the FAA.<sup>48</sup> Finally, lower courts have not resolved whether state laws that apply to other types of contracts in addition to arbitration agreements, but not to contracts in general, are preempted by the FAA.<sup>49</sup> One example of such state laws is a law restricting forum-selection clauses.

Lower courts have consistently followed Supreme Court precedent in striking down state laws that single out arbitration agreements. If a state statute, court decision, or regulation explicitly prohibits or finds unconscionable all arbitration agreements, courts after *Southland* have been unanimous in holding that the FAA preempts

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44. *Moses H. Cone Memorial Hosp. v. Mercury Constr. Corp.*, 460 U.S. 1, 24-25 (1983).

45. The present state of arbitration under the FAA has been criticized by many commentators. See, e.g., Thomas E. Carbouneau, *Arbitral Justice: The Demise of Due Process in American Law*, 70 TUL. L. REV. 1945 (1996); 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, *Panacea or Corporate Tool?: Debunking the Supreme Court's Preference for Binding Arbitration*, 74 WASH. U. L.Q. 637 (1996). But see Jonathan E. Breckenridge, *Bargaining Unfairness and Agreements to Arbitrate: Judicial and Legislative Application of Contract Defenses to Arbitration Agreements*, 1993 ANN. SURV. AM. L. 925, 926 (in favor of present law). The wisdom of the Supreme Court's interpretation of the FAA is outside the scope of this Note.

46. See *infra* notes 54-64 and accompanying text.

47. See *infra* note 50 and accompanying text.

48. See *infra* notes 54-64 and accompanying text.

49. See *infra* Part II.C.

state law.<sup>50</sup> Lower courts have also followed the Supreme Court's language from *Moses H. Cone* and resolved all doubts about a contractual provision in favor of arbitration.<sup>51</sup>

Several courts have also held or noted in dicta that the FAA preempts provisions of state franchise laws which restrict the use of arbitration agreements.<sup>52</sup> In all of these cases, however, with the exception of those that deal with statutes that restrict forum-selection clauses,<sup>53</sup> the statute in question "singled out" arbitration agreements for suspect treatment or outright prohibition, without any parallel restrictions on forum-selection clauses. Thus, these cases offer little insight regarding preemption of statutes restricting forum-selection clauses.

In contrast, lower courts also have consistently held that fraud, duress, unconscionability, or other contract defenses may invalidate arbitration agreements without violating the FAA.<sup>54</sup> Those cases holding arbitration agreements unconscionable and thus unenforceable are particularly instructive. As noted above, the FAA will preempt a state statute or judicial decision which finds *all* arbitration agreements unconscionable.<sup>55</sup> Many courts, however, have struck down arbitration agreements as unconscionable, despite the FAA, if

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50. See, e.g., *David L. Threlkeld & Co. v. Metallgesellschaft Ltd.*, 923 F.2d 245, 250-51 (2d Cir. 1991) (holding that the FAA preempted a state statute requiring 10-point capital letters providing notice for an arbitration clause); *Bayma v. Smith Barney, Harris Upham & Co.*, 784 F.2d 1023, 1025 (9th Cir. 1986) (holding preempted a state law that held all arbitration agreements in employment contracts invalid as contracts of adhesion).

51. The Court in *Moses H. Cone* noted that because the FAA established national policy favoring arbitration, "any doubts . . . should be resolved in favor of arbitration." *Moses H. Cone Mem'l Hosp. v. Mercury Constr. Corp.*, 460 U.S. 1, 24-25 (1983). Lower courts have cited this language numerous times. See, e.g., *Doctor's Assocs. v. Stuart*, 85 F.3d 975, 981 (2d Cir. 1996) ("[A]ny doubts concerning whether there has been a waiver are resolved in favor of arbitration.") (citation omitted).

52. See, e.g., *Saturn Distribution Corp. v. Williams*, 905 F.2d 719, 724-27 (4th Cir. 1990) (holding that the FAA overrides a state franchise statute which prohibited automobile manufacturers and dealers from assenting to mandatory arbitration agreements); *Seymour v. Gloria Jean's Coffee Bean Franchising Corp.*, 732 F. Supp. 988, 994 (D. Minn. 1990) (stating that the FAA preempts a state franchise law prohibiting predispute arbitration agreements in franchise agreements); *Davis v. Rentrak Corp.*, No. 88-69614, 1989 WL 2047, at \*5-\*7 (N.D. Ill. Jan. 6, 1989) (noting that the FAA preempted the state franchise law even if the state law was construed to void arbitration agreements). See also the discussion of the Supreme Court's holding in *Southland Corp. v. Keating*, 465 U.S. 1 (1984), *supra* notes 25-29 and accompanying text.

53. See *infra* Part II.C (discussing cases addressing statutes that restrict forum-selection).

54. This rule comes from the text of the FAA which upholds arbitration agreements "save upon such grounds as exist at law or in equity for the revocation of any contract." 9 U.S.C. § 2 (1994).

55. See, e.g., *Bayma*, 784 F.2d at 1023 (holding preempted state law that invalidates all arbitration agreements in employment contracts).

the terms of the agreement are one-sided and the inequality of bargaining power is great.<sup>56</sup>

Courts have found arbitration agreements unconscionable for a variety of reasons. The most common example of unconscionability in arbitration agreements is where the arbitrator chosen holds a bias in favor of a particular party.<sup>57</sup> Three other factors that some courts have found to be evidence of unconscionability include (1) one party burdened with an unfair share of the costs of arbitration; (2) lack of mutuality;<sup>58</sup> and (3) unreasonable restrictions on the arbitrator's ability to provide a remedy.<sup>59</sup>

Some courts have also found arbitration agreements to be substantively unconscionable because the agreement subjected one party to a remote forum. In *Patterson v. ITT Consumer Financial Corp.*, the California Court of Appeals held an arbitration agreement unconscionable, in part, because it required California residents to arbitrate any disputes in Minnesota.<sup>60</sup> The California Court of Appeals has used similar reasoning to scrutinize and strike down arbitration agreements calling for remote forums.<sup>61</sup>

In contrast, in federal court these claims have been less successful.<sup>62</sup> Federal courts seem to require a strong showing of procedural unconscionability, in addition to a substantive showing of an unconscionable remote forum.<sup>63</sup> Nonetheless, these cases demonstrate

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56. Unconscionability is generally seen as having two requirements: (1) procedural unconscionability, which means a gross inequality in bargaining power; and (2) substantive unconscionability, which means unfairness in the substantive terms of the contract. See ALLAN E. FARNSWORTH, *CONTRACTS* § 4.28 (2d ed. 1990). Part II.B focuses on the terms of arbitration agreements that courts have found unconscionable, thus addressing only substantive unconscionability.

57. See *Graham v. Scissor-Tail, Inc.*, 623 P.2d 165 (Cal. 1981) (finding the arbitrator chosen "presumptively biased" in favor of one party and thus the clause unconscionable). For a detailed discussion and analysis of these and other cases finding unconscionable arbitration agreements, see Stephen J. Ware, *Arbitration and Unconscionability after Docter's Associates, Inc. v. Casarotto*, 31 WAKE FOREST L. REV. 1001, 1018-34 (1996).

58. The conditions for lack of mutuality exist when one party is bound to have its claims arbitrated in court but the other is free to bring suit. See Ware, *supra* note 57, at 1024.

59. See *id.* at 1023-26 (discussing these three factors).

60. See 18 Cal. Rptr. 2d 563, 565-66 (Cal. Ct. App. 1993).

61. See *Bos Material Handling, Inc. v. Crown Controls Corp.*, 186 Cal. Rptr. 740, 745 (Ct. App. 1982) (remanding case for determination of whether location of arbitration in Ohio is unconscionable); *Player v. Geo. M. Brewster & Son, Inc.*, 96 Cal. Rptr. 149, 154-56 (Cal. Ct. App. 1971) (finding an exception to the arbitration clause in the contract but noting in dicta that even without the exception clause the validity of the agreement would be in doubt and calling on courts to "scan closely contracts which bear facial resemblance to contracts of adhesion and which contain cross-country arbitration clauses").

62. See Breckenridge, *supra* note 45, at 966.

63. See, e.g., *China Resource Prods. U.S.A., Ltd. v. Fayda Int'l, Inc.*, 747 F. Supp. 1101, 1107 (D. Del. 1990) (upholding an arbitration in China due to sophistication of parties); *Tennessee Imports, Inc. v. Filippi*, 745 F. Supp. 1314, 1326-28 (M.D. Tenn. 1990) (finding

that courts will entertain arguments regarding the fairness of particular arbitration agreements and, despite the FAA, will strike down arbitration agreements deemed unconscionable.<sup>64</sup>

### C. Applying the FAA to State Laws Restricting Forum-Selection

The most recent case addressing forum-selection laws is *Alphagraphics Franchising v. Whaler Graphics, Inc.*<sup>65</sup> In *Alphagraphics*, the franchisor and franchisee entered into a franchise agreement that included a provision for arbitration in Arizona in the event of a dispute.<sup>66</sup> The franchise was to do business in Michigan.<sup>67</sup> The franchisor filed suit attempting to compel arbitration, and the franchisee raised as a defense the Michigan Franchise Investment Law,<sup>68</sup> which invalidated forum-selection and arbitration agreements that selected out-of-state venues.<sup>69</sup> The court held that the Michigan law was preempted by the FAA, because the law focused on arbitration agreements more than other contracts.<sup>70</sup> The court went on to hold, however, that the arbitration agreement was the product of fraudulent inducement, thus voiding the agreement and casting doubt on the precedential value of the preemption holding.<sup>71</sup>

Several older cases from Puerto Rico also have examined the interplay between state restrictions on forum-selection and the FAA.<sup>72</sup> The courts in these cases have concluded that the FAA preempted a Puerto Rican statute that voided remote forum-selection clauses in dealership contracts.<sup>73</sup> In *Mitsubishi Motors Corp. v. Soler Chrysler-Plymouth, Inc.*, an automobile dealer brought a counterclaim against its manufacturer-supplier, claiming breach of contract and violation of

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arbitration in Italy for American company not unconscionable, because the American company was a sophisticated business with international experience and could not show any unfair lack of bargaining power).

64. See *supra* notes 57-61 and accompanying text.

65. 840 F. Supp. 708 (D. Ariz. 1993).

66. See *id.* at 709.

67. See *id.*

68. MICH. COMP. LAWS ANN. § 445.1527(f) (West 1997). See *infra* notes 119-20 and accompanying text for a discussion of this statute.

69. See *id.*

70. See *Alphagraphics*, 840 F. Supp. at 710. The court did not elaborate.

71. See *id.* at 711.

72. See *infra* notes 73-78 and accompanying text.

73. See *Michael v. NAP Consumer Elecs. Corp.*, 574 F. Supp. 68, 69 (D.P.R. 1983). The statute declares that "any stipulation that obligates a dealer to adjust, arbitrate or litigate any controversy that comes up regarding his dealer's contract outside of Puerto Rico . . . is therefore null and void." P.R. Laws Ann., tit. 10 § 278b-2 (1997).

state and federal law.<sup>74</sup> The manufacturer sought to compel arbitration of the dealer's counterclaims, and, in response, the dealer argued that the state law invalidated the arbitration clause in the dealer agreement.<sup>75</sup> The First Circuit Court of Appeals held that the FAA preempted the Puerto Rican law, because the law singled out arbitration.<sup>76</sup> As in *Alphagraphics*, the *Mitsubishi* court did not elaborate on why the state law singled out arbitration.<sup>77</sup> The district court in Puerto Rico has followed *Mitsubishi Motors* and held that the law as applied to arbitration is preempted by the FAA.<sup>78</sup>

Although these cases will doubtless be cited by those who argue for arbitration under similar circumstances, the cases are of limited value. First, the precedential value of *Alphagraphics* is limited because the discussion of the issue is in dicta.<sup>79</sup> More importantly no court in any of these cases provides an explanation for its conclusion. The extent of the preemption analysis in each case is the conclusory statement that the statute "singled out" arbitration. Presumably, the court concluded that the statute unfairly singled out arbitration because the statute applied specifically to arbitration. Each statute in question, however, also applied to all forum-selection clauses. Also absent from these cases is any analysis of the policies underlying the state statute in question and the policy behind the FAA.

In sum, current case law does not resolve whether the the FAA preempts statutes invalidating forum-selection clauses. The few cases on point suggest that the FAA should preempt state law. These cases have limited precedential value, however, and do not fully explore the conflicting policies at issue. The extensive body of case law on general FAA preemption has produced no analogous cases. Nearly all of these cases either strike down laws that apply only to arbitration or uphold the use of general contract law to invalidate

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74. See 723 F.2d 155, 157-58 (1st Cir. 1983), *aff'd in part and rev'd in part on other grounds*, 473 U.S. 614 (1985). The FAA preemption of the Puerto Rican law was not contested before the Supreme Court. See *Mitsubishi Motors*, 473 U.S. at 622 n.8.

75. See *id.* The dealer actually did not argue that the Puerto Rican law applied directly; rather, it argued that the law was "incorporated" into the dealership agreement. *Id.* at 158.

76. See *id.*

77. See *id.*

78. See *Michael*, 579 F. Supp. at 69-70 (D.P.R. 1983) (finding the same statute preempted by the FAA two months before the *Mitsubishi Motors* case was decided, but apparently misreading the statute to invalidate all arbitration agreements); *Sea-Land Serv., Inc. v. Sea-Land of P.R., Inc.*, 636 F. Supp. 750, 753 (D.P.R. 1986) (noting in dicta the holding from *Mitsubishi*); *Protane Gas Co. of P.R., Inc. v. Sony Consumer Prods. Co.*, 613 F. Supp. 215, 217 (D.P.R. 1985) (following *Mitsubishi* and upholding an arbitration agreement in spite of the state law).

79. See *Alphagraphics Franchising v. Whaler Graphics, Inc.*, 840 F. Supp. 708, 711 (D. Ariz. 1993).

arbitration agreements.<sup>80</sup> To resolve this issue, courts must look beyond precedent and, instead, focus on the policies underlying the both the FAA and the state laws restricting forum-selection clauses.

### III. FORUM-SELECTION CLAUSES AND FRANCHISE AGREEMENTS

Recently, the law governing the validity of forum-selection clauses has changed rapidly. Specifically, the Supreme Court has held forum-selection clauses presumptively valid under federal law.<sup>81</sup> As a result, many states have reversed long-standing common law holding forum-selection clauses invalid. Many states, however, have begun to apply new restrictions on forum-selection clauses in contracts where the imbalance of bargaining power is great. In particular, several states now have laws that restrict the use of forum-selection clauses in franchise agreements.<sup>82</sup> The following section discusses both the current federal law favoring forum-selection clauses, and the particular state laws that limit the use of the clauses in franchise agreements.

#### A. *Presumptive Validity of Forum-Selection Clauses Under Federal Law*

The general rule the Supreme Court has promulgated is that forum-selection clauses are "prima facie valid."<sup>83</sup> In order to rebut this presumption of validity, a party must show that the clause is unreasonable under the circumstances.<sup>84</sup> This presumption was announced in *The Bremen v. Zapata Off-Shore Co.*, in which the Court abandoned the historical view of disfavoring forum-selection clauses<sup>85</sup> and upheld a forum-selection clause that provided for a dispute between an American and a German company to be resolved in the

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80. See *supra* Part II.B.

81. See *The Bremen v. Zapata Off-Shore Co.*, 407 U.S. 1, 10 (1972).

82. See *infra* Part III.B.

83. See *The Bremen*, 407 U.S. at 10.

84. See *id.*

85. See *id.* Courts before *The Bremen* often did not enforce forum-selection clauses under the rationale that, as with arbitration agreements, forum-selection clauses "ousted" the jurisdiction of the court. *Id.* The Court rejected this policy in *The Bremen*. Note that the rationale behind many present-day laws limiting forum-selection clauses are quite different from this "ousting" rationale, however, as these state laws are concerned with the hardship imposed by requiring a party to have its claim heard in a remote location. See *infra* Part IV.B for a discussion of this distinction.

London Court of Justice.<sup>86</sup> The Court noted that this clause was negotiated freely by the parties and was not so inconvenient to one party as to erect an insurmountable barrier to judicial redress.<sup>87</sup>

The Court expanded its "presumptive validity" of forum-selection clauses to cover adhesion contracts in *Carnival Cruise Lines, Inc. v. Shute*.<sup>88</sup> In *Carnival Cruise Lines*, the Court enforced a forum-selection clause printed on the ticket of a cruise passenger ticket, which required the plaintiff, a Washington resident, to bring suit in Florida.<sup>89</sup> Relying on the plaintiff's failure to claim lack of notice of the forum-selection clause and the Court's determination that Florida was not a "remote alien forum," the Court held that the rule from *The Bremen* was controlling and that the clause was enforceable.<sup>90</sup>

Thus after *Carnival Cruise Lines*, regardless of the type of contract or remoteness of the forum, the federal law presumes that forum-selection clauses are valid. A party may rebut this presumption with a showing of serious unfairness in the bargaining process or in the location of the forum.<sup>91</sup> The presumption has far-reaching effects because the Supreme Court has also held that, in at least some situations, federal courts must apply the federal law of forum-selection clauses in diversity and federal question cases.<sup>92</sup> For example, in *Stewart Organization, Inc. v. Ricoh Corp.*, the Court held that when a party relies on a forum-selection clause in a motion to transfer venue pursuant to the federal venue statute,<sup>93</sup> federal law applies to determine the construction and validity of the forum-selection clause.<sup>94</sup> The context in which arbitration agreements will

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86. See *The Bremen*, 407 U.S. at 4.

87. See *id.* at 12-13.

88. See 499 U.S. 585, 594-95 (1991).

89. See *id.* at 588, 594-95.

90. See *id.*

91. Note that current law, which basically requires the application of general contract defenses to invalidate forum-selection clauses, closely parallels the Supreme Court's treatment of arbitration clauses under the FAA. See *infra* Part II.A for a discussion of the Supreme Court's interpretation of the FAA.

92. This extension of the law demonstrates that the law of forum-selection clauses is not restricted to admiralty cases such as *The Bremen* and *Carnival Cruise Lines*.

93. 28 U.S.C. § 1404 (1994). This section of the statute provides that "[f]or the convenience of the parties and witnesses, in the interest of justice, a district court may transfer any civil action to any other district or division where it might have been brought." *Id.* § 1404(b). The statute allows any party to an action to file a motion for transfer of venue. See *id.* Typically, a party seeking to enforce a forum-selection clause will file a transfer of venue motion, and offer the forum-selection clause as evidence in support of the motion. See, e.g., *The Bremen*, 407 U.S. at 4-5 (demonstrating the use of this strategy).

94. See *Stewart Org., Inc. v. Ricoh Corp.*, 487 U.S. 22, 32 (1988). The application of federal forum-selection law to a transfer of venue case does not necessarily mean that unless there is something akin to unconscionability in the forum-selection agreement, the motion will

be raised is in a motion to dismiss, because the arbitration clause selects a forum outside the court system. The Supreme Court has yet to rule on whether federal or state law applies when a forum-selection clause is offered as evidence in support of a motion to dismiss. The circuit courts are divided on the issue.<sup>95</sup>

### *B. State Laws Invalidating Forum-Selection Clauses in Franchise Agreements*

Although federal law has consistently held that forum-selection clauses are presumptively valid, many states restrict the validity of forum-selection clauses in particular circumstances. Currently, thirteen states have judicial rules, statutes, or administrative rules which either hold forum-selection clauses in franchise agreements invalid or subject them to a high degree of scrutiny when the clauses specify a forum outside of a franchisee's home state.<sup>96</sup> Many of these laws have been enacted recently and reflect a trend towards increased scrutiny of these types of clauses, particularly in franchise agreements.<sup>97</sup>

#### 1. Judicial Rules

Several state courts have recently adopted rules that hold certain forum-selection clauses presumptively invalid or subject to a standard of review higher than the standard under federal law. The New Jersey Supreme Court pronounced the strongest anti-forum selection law in *Kubis & Perszyk Associates v. Sun Microsystems*.<sup>98</sup> Although less stringent than the New Jersey Supreme Court's

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be granted. In a transfer of venue motion, the district court must consider a variety of factors which may include the state law's treatment of forum-selection clauses.

95. See, e.g., *Manetti-Farrow, Inc. v. Gucci Am., Inc.*, 858 F.2d 509, 512-13 (9th Cir. 1988) (discussing the split in the circuits over whether state or federal forum-selection law applies, and deciding that federal law applies). The difference between a motion to transfer and a motion to dismiss is that in a motion to transfer, a federal statute (28 U.S.C. § 1404) is directly on point, whereas no statute directly applies to a motion to dismiss. See *id.* at 512. See *Stewart*, 487 U.S. at 26-32, for a complete discussion of the *Erie* analysis that led the Court to its conclusion that federal law applied in the context of a section 1404 transfer motion. See generally Robert A. de By, Note, *Forum-Selection Clauses: Substantive or Procedural for Erie Purposes*, 89 COLUM. L. REV. 1068, 1079-83 (1989) (discussing the circuit split and arguing that state law should apply in federal court for purposes of a motion to dismiss). In state courts, state law of forum-selection clauses applies.

96. The states are California, Illinois, Indiana, Iowa, Maryland, Michigan, Minnesota, New Jersey, North Carolina, North Dakota, Rhode Island, South Dakota, and Washington.

97. See Brenner, *supra* note 6, at 108-13; Levin & Morrison, *supra* note 5, at 92.

98. 680 A.2d 618 (N.J. 1996).



decision, other courts' scrutiny of forum-selection clauses also arguably conflicts with the federal rule of presumptive validity.<sup>99</sup>

In *Kubis* the plaintiff, a franchisee of a retail computer company, brought suit claiming violations of the New Jersey Franchise Practices Act<sup>100</sup> and tortious interference with business relationships after the defendant had terminated the parties' agreement.<sup>101</sup> The agreement in question included a forum-selection clause which stated that a California court was the exclusive forum for adjudicating disputes over the agreement.<sup>102</sup> The defendant moved to dismiss the case pursuant to the forum-selection clause, and the New Jersey trial court granted the motion.<sup>103</sup>

The New Jersey Supreme Court reversed, holding the forum-selection clause unenforceable and announcing a rule that forum-selection clauses in agreements subject to the Franchise Practices Act are presumptively invalid.<sup>104</sup> The court reasoned that enforcement of forum-selection clauses would frustrate the protections that the legislature intended to provide to franchisees: the protection from the problems of "unequal bargaining power and the unavailability of prompt judicial relief."<sup>105</sup> Thus, in order to move a New Jersey court to uphold a forum-selection clause in a franchise contract, a franchisor must show that the clause was a product of a real bargain and not merely a boilerplate clause in a contract of adhesion.

Several states have case law upholding forum-selection clauses only if the clauses are demonstrated to be reasonable and not the product of unfair bargaining power.<sup>106</sup> Many of these states apply

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99. Compare *Kubis*, 680 A.2d at 626 (holding forum-selection clauses in franchise agreements presumptively invalid), with *Cutter v. Scott & Fetzer Co.*, 510 F. Supp. 905, 909 (E.D. Wis. 1981) (requiring free bargaining but not applying a presumption of invalidity).

100. N.J. STAT. ANN. §§ 56:10-1 to 56:10-15 (West 1989).

101. See *Kubis*, 680 A.2d at 619-20.

102. See *id.* at 618.

103. See *id.* at 620.

104. See *id.* at 626.

105. *Id.* at 622. The court took special note of the fact that the Franchise Practices Act had a provision which invalidated forum-selection clauses in automobile dealership franchise agreements. See *id.* at 623. This provided further support for the policy the court found apparent in the Act. The dissent disagreed, arguing that the legislature's adoption of the law for automobile franchises but not for all franchises signaled its rejection of the idea. See *id.* at 631 (Garibaldi, J., dissenting). At the end of the opinion, the court emphasized that the rule it had fashioned was not the result of a worry over the ability of another court system to adequately protect franchisees. See *id.* at 628. Rather, the rule was a recognition of the fact that even if the same relief could be afforded in another jurisdiction, the accessibility of a far-away jurisdiction to a typical franchisee may be practically nonexistent. See *id.*

106. See *Davis v. Great Am. Cleaners, Inc.*, Bus. Franchise Guide (CCH) ¶ 10,979 (Mass. Sup. Ct. July 23, 1996) (invalidating forum-selection clause in franchise agreement because of imbalance of bargaining power and serious inconvenience to franchisee); see also *Cutter v. Scott & Fetzer Co.*, 510 F. Supp. 905, 908-09 (E.D. Wis. 1981) (refusing to enforce forum-selection

rules that arguably are stricter than both the federal law of forum-selection and the general state law of unconscionability.<sup>107</sup> The question remains whether one of these laws, if applied to invalidate an arbitration clause, would be in conflict with the FAA. Arguably, in this case the arbitration clause is held to a stricter standard than other contracts generally.<sup>108</sup>

All of these decisions invalidate forum-selection clauses that would have forced resolution in another *judicial* forum. None of the cases deals with or discusses arbitration agreements. Thus it is not clear whether the rules from these cases would be applied to arbitration agreements that select a remote forum. With the FAA and its apparent national policy in favor of arbitration, different considerations arise when arbitration agreements are at stake.<sup>109</sup> However, the policies underlying the invalidation of judicial forum-selection clauses, such as guarding against abuse of unequal bargaining power and protecting the franchisee's ability to easily seek redress, apply equally to arbitration agreements that select a remote forum. As the *Kubis* court stated, whether the franchisee would be able to seek redress in the venue at all without great expense and inconvenience was the concern addressed.<sup>110</sup> The court was not interested in whether the alternative venue would adequately protect

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clause because clause was not freely bargained for, inconvenience of forum was evenly balanced, and Wisconsin dealership laws created a public policy in favor of adjudication in Wisconsin); *Horner v. Tiltan*, 650 N.E.2d 759, 763 (Ind. Ct. App. 1995) (upholding forum-selection clause but requiring that it be reasonable, just, and freely negotiated); *see also* Brenner, *supra* note 6, at 108-12 (discussing these and other similar cases).

107. *Compare Cutter*, 510 F. Supp. at 908-09 (invalidating forum-selection clause because of inequality of bargaining power, even though each party was equally inconvenienced by the location), *with* *Carnival Cruise Lines, Inc. v. Shute*, 499 U.S. 585, 594 (1991) (upholding forum-selection clause in adhesion contract that required a Washington resident to bring suit in Florida, the other party's home state).

108. Although this Note focuses on state laws that apply to forum-selection clauses in franchise agreements, the situation above would raise many of the same issues regarding FAA preemption.

At least four states adhere to the old common law rule of strict invalidity of all forum-selection. *See* *Keelean v. Central Bank of the South*, 544 So. 2d 153, 156 (Ala. 1989); *Cartridge Rental Network v. Video Entertainment*, 209 S.E.2d 132, 132 (Ga. App. 1974); *State ex rel. Polaris Indus. v. District Court*, 695 P.2d 471, 471-72 (Mont. 1985); *Dowling v. NADW Mktg.*, 578 S.W.2d 475, 476 (Tex. Civ. App. 1979), *rev'd on other grounds*, 631 S.W.2d 726 (Tex. 1982). These rules are premised on a policy against "ousting" the state court of jurisdiction, rather than protection of bargaining power. *See de By*, *supra* note 95, at 1071.

109. The Supreme Court first found this "national policy" in favor of arbitration implicit in the FAA in *Moses H. Cone Memorial Hospital*. 460 U.S. 1, 24-25 (1983). Thus, the Court concluded, to further this policy, all doubts should be resolved in favor of arbitration. *See id.* Because no comparable national policy in favor of forum-selection clauses exists at the state level, states may want to treat arbitration clauses more favorably than similar forum-selection clauses.

110. *See supra* note 105.

the franchisee's rights. Thus these judicial rules are likely to apply to arbitration clauses as well.<sup>111</sup>

## 2. Statutes

Many states have enacted statutes which invalidate forum-selection clauses in franchise agreements that select an out-of-state forum.<sup>112</sup> The wording of these statutes, however, differs from state to state. For example, some statutes invalidate forum-selection clauses in general. Others specifically invalidate arbitration clauses or exclude arbitration clauses from the reach of the statute.

### *a. Statutes With No Express Reference to Arbitration Clauses*

California, Rhode Island, and South Dakota have statutes which void forum-selection clauses in franchise agreements that select an out-of-state forum.<sup>113</sup> None of these statutes distinguishes litigation from arbitration. Each statute uses the phrase "restricting jurisdiction or venue to a forum" in describing the proscribed forum-selection clauses.<sup>114</sup> Because any judicial or administrative law on these statutes is unreported, it remains unclear whether the statutes apply to arbitration agreements as well as litigation-oriented clauses. Arguably, the use of the words "jurisdiction" and "venue" suggest application only to litigation. However, the use of the general word "forum" instead of "court" or another term specific to litigation suggests application to arbitration clauses.<sup>115</sup>

In addition, the general policy behind state franchise laws supports the application of these laws to arbitration agreements. State franchise laws are designed to protect franchisees from unfair treatment as a result of their lesser bargaining power.<sup>116</sup> A legislative intent to protect franchisees from the unfairness in having to travel to

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111. See *Franchise Agreement Arbitration Clauses Are Here to Stay . . . Or Are They?*, *supra* note 7, at 173 (noting that arbitration clauses are "ripe for challenge in New Jersey" after *Kubis*).

112. See *infra* notes 113-28 and accompanying text.

113. See CAL. BUS. & PROF. CODE § 20.40.5 (West 1990); R.I. GEN. LAWS § 19-28.1-14 (1989); S.D. CODIFIED LAWS § 37-5A-51.1 (Michie 1994).

114. See *id.*

115. An arbitration agreement is widely recognized as a "specialized forum-selection clause." See *supra* note 4.

116. See, e.g., *Kubis & Perszyk Assocs. v. Sun Microsystems, Inc.*, 680 A.2d at 618, 627-28 (N.J. 1996) (noting that the purpose of the New Jersey Franchise Act is to protect against exploitation of franchisees because of their inferior bargaining power); *Horner v. Tilton*, 650 N.E.2d 759, 762 (Ind. Ct. App. 1995) (reaching a similar conclusion about the purpose of the Indiana franchise laws).

a remote forum for dispute resolution underlies these particular forum-selection statutes.<sup>117</sup> This rationale should apply regardless of the type of forum in which the dispute will be heard.<sup>118</sup>

*b. Statutes Explicitly Applicable to Arbitration Clauses*

North Carolina and Michigan have statutes that explicitly include arbitration clauses in the franchise statute invalidating forum-selection clauses.<sup>119</sup> Under Michigan's Franchise Investment Law, a provision in a franchise agreement requiring out-of-state litigation or arbitration is void and unenforceable.<sup>120</sup> North Carolina's statute applies not only to franchise agreements but to most contracts entered into in North Carolina that require litigation or arbitration of any dispute over the contract in an out-of-state forum.<sup>121</sup> Any agreements that fall within the broad scope of this provision are void and unenforceable.<sup>122</sup>

The purpose of each of these statutes is not spelled out in legislative history but can be inferred from the policy behind related statutes. In Michigan, the forum-selection statute is part of the Michigan Franchise Investment Law, which was enacted to protect franchisees from unfair surprise or hardship resulting from their

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117. Unfortunately no legislative history is available for the individual forum-selection statutes. However, given that the general rationale behind state franchise laws is to protect franchisees with inferior bargaining power from hardship, these statutes are likely directed specifically at protecting franchisees from being forced to travel to remote places to resolve disputes. State courts have inferred this rationale from general franchise statutes. See *Kubis*, 680 A.2d at 628; *Cutter v. Scott & Fetzer Co.*, 510 F. Supp. 905, 909 (E.D. Wis. 1981); see also Joseph E. Smith, Note, *Civil Procedure—Forum Selection—N.C. Gen. Stat. § 22B-3 (1994)*, 72 N.C. L. REV. 1608, 1611 (1994) (noting that the North Carolina anti-forum-selection statute was passed to protect those "with little bargaining power").

118. Alternatively, these statutes may be intended to address concerns about subjecting a franchisee to a foreign state's judicial "police power." Under this rationale, these statutes would not invalidate an arbitration clause because an out-of-state arbitration does not subject the franchisee to another state's legal power. The general policy behind these franchise statutes (to protect against abuse of franchisees) does not suggest this "police power" distinction. The hardship of a franchisee who travels to a remote location is unaffected by whether an arbitrator or court will resolve the dispute.

119. See MICH. COMP. LAWS ANN. § 445.1527(f) (West 1989); N.C. GEN. STAT. § 22B-3 (1997).

120. See MICH. COMP. LAWS ANN. § 445.1527(f) (West 1989). The statute makes an exception for arbitration agreements entered into after the dispute has arisen. See *id.*

121. See N.C. GEN. STAT. § 22B-3 (Michie 1997).

122. See *id.* The statute also makes an exception for arbitration agreements entered into after the dispute has arisen. See *id.* Puerto Rico also has a statute which invalidates forum-selection and arbitration clauses that call for out-of-state forums in dealer agreements. P.R. LAWS ANN., tit.10, § 278b-2 (1997). A dealer agreement is defined to include what is commonly thought of as a franchise agreement. This statute has been held to be preempted by the FAA as applied to arbitration agreements. See *supra* notes 73-78 and accompanying text.

relative lack of business savvy and legal knowledge and their inferior resources.<sup>123</sup> In North Carolina, the forum-selection statute is not part of a set of franchise laws. Instead, the statute applies to a broad range of agreements.<sup>124</sup> The legislature passed the statute to overrule a North Carolina Supreme Court decision and protect those with inferior bargaining power.<sup>125</sup>

*c. Statutes Excluding Arbitration from Their Purview*

Illinois, Indiana, Iowa, and Minnesota have franchise statutes that invalidate out-of-state forum-selection clauses, but all appear to except arbitration agreements. Illinois, Indiana, and Minnesota's statutes exclude arbitration agreements explicitly.<sup>126</sup> The scope of Iowa's statute is questionable. One section voids provisions restricting "jurisdiction to a forum outside [the] state," without explicitly mentioning arbitration.<sup>127</sup> In contrast, a later section of the statute provides that "[p]arties to a franchise may agree to independent arbitration, mediation, or other nonjudicial resolution of an existing or future dispute."<sup>128</sup> Thus it is unclear whether this section excludes arbitration agreements from the provision restricting forum selection or merely expressly allows parties to make these agreements subject to the restrictions of the forum-selection provision. Unfortunately, no reported case or administrative rule appears on this issue in Iowa, nor does any legislative history regarding the purpose of the statute.

The reason these states protect arbitration agreements from the reach of the forum-selection statute remains unclear. Perhaps the legislature was concerned that the FAA will preempt the law if the statute is applied to arbitration agreements.<sup>129</sup> Another possibility is that the forum-selection laws are concerned with subjecting a state resident to the "police power" of another state.<sup>130</sup> Regardless of the

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123. See *Geib v. Amoco Oil Co.*, 29 F.3d 1050, 1056 (6th Cir. 1994) (explaining the policy behind the law). For a detailed discussion of the Michigan Franchise Investment Law, see generally Richard H. May and David L. Steinberg, *Great Expectations: 1984 Amendments to Franchise Investment Law*, 64 MICH. BUS. L.J. 32 (1985).

124. The statute applies to all agreements entered into in North Carolina, with some exceptions. See N.C. GEN. STAT. § 22B-3 (Michie 1997).

125. See Smith, *supra* note 117, at 1613 (discussing the law's enactment).

126. 815 ILL. COMP. STAT. ANN. 705/4 (West 1997); IND. CODE § 23-2-2.7-1 (1997); MINN. STAT. § 2860.4400(J) (1997).

127. IOWA CODE ANN. § 523H.3(1) (West Supp. 1997). This section is quite similar to the statutes mentioned in note 113, which do not distinguish between arbitration and litigation.

128. See *id.* § 523H.3(3).

129. See Levin & Morrison, *supra* note 5, at 117 (suggesting this reason).

130. See *supra* note 118 for a discussion of this rationale.

rationale, franchisors in these states are free to include arbitration clauses requiring out-of-state resolution of their disputes.

### 3. Administrative Rules

In Maryland, North Dakota, and Washington, state administrators have construed broad franchise statutes that impose general obligations on franchisors, and ruled that under these laws, clauses which provide for litigation or arbitration outside the state are invalid. Maryland has no statute or judicial rule invalidating these clauses. However, under the Maryland Franchise Registration and Disclosure Law, state administrators require a franchise agreement to provide that the franchisee may sue in Maryland for alleged violations of the Maryland Franchise Registration and Disclosure Law.<sup>131</sup> No distinction between litigation and arbitration exists.<sup>132</sup>

North Dakota's franchise statute empowers the state Securities Commissioner to deny franchise registration if, in the Commissioner's opinion, the franchise agreement is "unfair, unjust, or inequitable to the franchisees."<sup>133</sup> The Commissioner has concluded that forum-selection clauses selecting out-of-state courts, and arbitration clauses providing for remote arbitration sites, are unfair, unjust, or inequitable and, therefore, in violation of the statute.<sup>134</sup> Similarly, in Washington, the Securities Administrator is given the power to interpret and enforce the state Franchise Investment Protection Act, and the Administrator has determined that a franchisor requiring an out-of-state arbitration clause violates the Act.<sup>135</sup>

## IV. ANALYSIS: STATE FORUM-SELECTION LAWS VS. THE FAA

Few reported cases discuss the conflict between the FAA and state laws limiting forum-selection clauses.<sup>136</sup> However, with the trend towards increased use of arbitration agreements in franchise agreements, and the increasing number of states instituting laws that protect franchisees against forum-selection clauses that are perceived as unfair, this issue will likely be an important one in the future. In

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131. See Levin & Morrison, *supra* note 5, at 117 (providing an explanation of this law).

132. See *id.*

133. See *id.* at 118.

134. See *id.*

135. See *id.*

136. See *Doctor's Assocs., Inc. v. Casarotto*, 116 S. Ct. 1652, 1656 (1996).

addition to resolution of the immediate question, this issue also has important implications for the scope of FAA preemption and the viability of state laws that restrict the use of arbitration agreements for reasons other than concerns about arbitration.

State franchise laws that invalidate forum-selection clauses selecting an out-of-state forum should not be preempted by the FAA. Three reasons support this result. First, these laws are outside the FAA's preemptive scope because they do not "single out" arbitration agreements and hold them to a higher standard. Second, these laws do not undermine the FAA's goals and policies. The laws are concerned with the unequal bargaining power and the unfairness of a remote forum, rather than general concern about arbitration agreements. Third, using the FAA to preempt these state laws and uphold arbitration agreements that would otherwise be struck down would, conflict with the FAA's fundamental purpose of placing arbitration agreements on the same footing as all other contracts.

*A. State Forum-Selection Laws Do Not Single Out Arbitration Agreements for Increased Scrutiny*

Consistently, the Supreme Court has held that state laws may not "single out" arbitration agreements and subject them to greater scrutiny than other agreements.<sup>137</sup> The Court, however, has also noted consistently that, as the text of the FAA provides, arbitration agreements can be invalidated "upon such grounds as exist at law or in equity for the revocation of any contract."<sup>138</sup> The Court has interpreted this phrase to allow general contract law to invalidate arbitration agreements, and many lower courts have responded.<sup>139</sup> In particular, lower courts have applied the doctrine of unconscionability to void arbitration agreements that are not the result of open bargaining, subjecting the party of lesser bargaining power to a biased arbitrator or to an arbitration at a highly inconvenient site.<sup>140</sup>

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137. See Casarotto, 116 S. Ct. at 1656.

138. 9 U.S.C. § 2 (1997).

139. See *supra* notes 57-61 and accompanying text.

140. See, e.g., *Graham v. Scissor-Tail, Inc.*, 623 P.2d 165, 169 (Cal. 1981) (stating clause was unconscionable due to biased arbitrator); *Patterson v. ITT Consumer Fin. Corp.*, 18 Cal. Rptr. 2d 563, 566-67 (Ct. App. 1993) (finding unconscionability due to foreign forum); see also *supra* notes 57-61 and accompanying text (discussing these and other related cases).

State laws limiting forum-selection in franchise agreements are a form of general contract law.<sup>141</sup> Instead of distinguishing arbitration agreements, these laws apply to all forum-selection clauses. This difference immediately distinguishes *Casarotto* and all other Supreme Court precedent on FAA preemption. The Supreme Court has never held that a state law which applies to more than just arbitration agreements is preempted. One can view these laws as a legislative ruling that any time a franchisor inserts a forum-selection clause into a franchise agreement providing for a forum out of the franchisee's state, the imbalance of bargaining power and hardship on the franchisee gives rise to unconscionability.

Of course, these state laws do not apply to all contracts. These laws apply only to forum-selection clauses in franchise agreements. Proponents of FAA preemption will argue that these state laws are *not* part of general contract law but are instead laws that invalidate only forum-selection and arbitration clauses. Thus, the argument goes, these laws hold forum-selection and arbitration agreements to a higher standard than contracts generally, violating the principle of *Casarotto*<sup>142</sup> and other cases.

This argument overlooks the important difference between the state laws struck down by the Supreme Court and the state laws discussed here. In *Casarotto*, for example, the Montana notice provision applied only to arbitration agreements.<sup>143</sup> Because it did not apply to other agreements, a logical inference is that the Montana legislature was particularly concerned about the potential effect of arbitration agreements. This type of rationale is what the FAA was designed to prevent and what the Supreme Court meant when it held that the FAA preempts statutes that hold arbitration to "suspect status."<sup>144</sup> The state laws invalidated in the other Supreme Court cases construing the FAA similarly scrutinized the arbitration agreements because of concerns over arbitration, rather than concerns over bargaining power or some other general contract concern.<sup>145</sup>

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141. See Traci L. Jones, Note, *State Law of Contract Formation in the Shadow of the Federal Arbitration Act*, 46 Duke L.J. 651, 676-77 (1996) (arguing that a forum-selection clause is part of contract law); Ware, *supra* note 57, at 1028.

142. 517 U.S. 681, 685 (1996).

143. *Id.*

144. *Id.* at 688.

145. See, e.g., *Southland Corp. v. Keating*, 465 U.S. 1, 5 (1984). The state law in *Southland* was a judicial decision requiring judicial consideration of claims brought under state franchise laws. This ruling seems to have as an underlying rationale a worry that arbitration will not adequately protect the rights of the franchisee. This type of suspicion over arbitration agreements is what the courts have interpreted the FAA to preempt. See *id.* at 16.



*B. State Forum-Selection Laws Address a Concern Entirely Distinct from Arbitration*

The state laws in question do not "single out" arbitration agreements. Instead, they are concerned with contractual issues very different from those that the FAA was designed to override. The FAA's purpose was to undo the courts' centuries-old aversion to arbitration agreements that arose because they provided for alternative dispute resolution.<sup>146</sup> In contrast, as discussed above, the purpose behind the state laws restricting forum-selection clauses is to prevent the abuse of franchisees by powerful franchisors who are more sophisticated and have far more resources available.<sup>147</sup> This protection of the franchisee is a legitimate application of state contract law and is distinct from the FAA's rationale.

As the Supreme Court has stated many times, the central purpose behind the FAA was to override judicial hesitation to enforce arbitration agreements.<sup>148</sup> Before the enactment of the FAA, courts regularly invalidated arbitration agreements, often without any actual scrutiny of the fairness of the agreement.<sup>149</sup> The typical rationale was that arbitration agreements were void or voidable at the will of either party because, if enforced, they would "oust the jurisdiction of the court."<sup>150</sup> The FAA supplanted this judicially-made law by requiring arbitration agreements to be held to the same standard as all contracts. Today, in light of the text of the FAA and the Supreme Court's construction of it, no one legitimately can argue that arbitration agreements can be voided merely because they "oust the jurisdiction of the court."

Standing in stark contrast to this "ousting" rationale is the rationale behind today's state statutes and rules that invalidate forum-selection clauses. As noted above, the general policy behind state franchise laws is to protect franchisees from abuse because of their inferior bargaining power.<sup>151</sup> The specific statutes, rules, and decisions that restrict the use of forum-selection and arbitration clauses

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146. See, e.g., *Prima Paint Corp. v. Flood & Conklin Mfg. Co.*, 388 U.S. 395, 404 (1967) (discussing this purpose behind the FAA).

147. See *Kubis v. & Perszyk Assocs. v. Sun Microsystems, Inc.*, 680 A.2d 618, 621-26 (N.J. 1996) (discussing adhesion contracts and forum selection clauses); see also *supra* notes 117-18 and accompanying text (discussing the policy behind these state laws).

148. See *Doctor's Assocs. v. Casarotto*, 517 U.S. 681, 116 S. Ct. 1652 (1996).

149. See *Diamond*, *supra* note 20, at 35-37 (discussing the history of these arguments).

150. See *id.* at 36 n.2.

151. See *supra* notes 116-17 and accompanying text for a discussion of the policy behind state franchise laws.

follow this general policy by protecting franchisees from the burden of traveling to a distant forum to resolve their disputes.<sup>152</sup> These laws reflect no concern over courts' jurisdiction being "ousted." A statement from the *Kubis* court is particularly instructive:

Parochialism plays no role in our decision. We have no doubt that courts in other states, both state and federal, would faithfully and fairly apply the [New Jersey] Franchise Act to suits within their jurisdiction . . . . We recognize, however, that even if a California and a New Jersey court afforded identical relief under the Act to an aggrieved franchisee, there may be a difference of substantial magnitude in the practical accessibility of that relief from the perspective of an unsophisticated and underfinanced New Jersey franchisee.<sup>153</sup>

As the language from *Kubis* demonstrates, these laws are based on neither any increased suspicion or dislike of arbitration clauses, nor any concern that the court's jurisdiction will be "ousted." Rather, these laws are designed to prevent franchisors from effectively taking away a franchisee's right to seek redress for a breach of the franchise contract. A law which protects the rights of parties with inferior bargaining power can be considered general contract law. At the least, this type of law is clearly unrelated to the policy that the FAA was designed to preempt.<sup>154</sup>

*C. FAA Preemption of State Forum-Selection Laws Would Undermine the Overriding Policy of the FAA*

Ironically, the FAA's policy of placing arbitration agreements on the same level as other agreements would be undermined if the FAA preempted state forum-selection laws. A comparison of two franchise agreements illustrates this irony: (1) One franchise agreement contains an arbitration clause requiring any dispute to be resolved before an arbitrator in the franchisor's home state, far from the franchisee's home; (2) the other franchise agreement has a judicial forum-selection clause requiring that any suit be filed in court in the franchisor's home state, also far from the franchisee's home. Assume the franchisee operates in a state that has adopted a law invalidating forum-selection clauses selecting out-of-state sites for resolution.

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152. While many of these state laws do not have legislative history or other explicit evidence of the policy behind them, this purpose seems fitting in light of the general policy behind franchise laws. See *infra* Part III.B for discussion of these state laws and the policy behind them.

153. *Kubis & Perszyk Assocs. v. Sun Microsystems, Inc.*, 680 A.2d 618, 628 (N.J. 1996).

154. See *supra* note 20.

Assuming further the application of state forum-selection law,<sup>155</sup> the forum-selection clause designating the out-of-state court would be invalidated. In contrast, if the FAA preempts the state law as applied to the arbitration agreement, a court would uphold the arbitration agreement. Thus, the arbitration agreement would not be on the same level as the other agreement. Instead, the forum-selection agreement would be invalidated and the arbitration agreement would be upheld, even though both agreements present the same "remote forum" problem the state law is designed to remedy<sup>156</sup> and both are equally invalid under state law.<sup>157</sup>

This result is fundamentally at odds with the FAA's purpose. By enacting the FAA, Congress intended to eliminate judicial hostility to arbitration agreements and require equal enforcement of arbitration agreements and other contract provisions.<sup>158</sup> As the example above demonstrates, this ironic result places arbitration agreements on a *higher* level than other contracts. As the Supreme Court stated in *Prima Paint*, the FAA is supposed "to make arbitration agreements as enforceable as other contracts, but not more so."<sup>159</sup> If the FAA is held to preempt these state laws as applied to arbitration agreements, arbitration agreements will be favored over forum-selection clauses. Congress intended no such result.<sup>160</sup>

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155. In federal court, federal law may apply to the enforcement of a forum-selection provision. See *supra* notes 92-95 and accompanying text.

156. Again, one may argue that the state law was designed merely to protect an in-state franchisee from another state's "police power." Given the judicial reasoning and legislative intent behind these state laws, however, this explanation is hardly plausible. See *supra* note 118 and accompanying text for a discussion of this possibility.

157. Puerto Rico's law has this exact inconsistency. In *Mistubishi Motors*, the First Circuit held that the FAA overruled a local statute invalidating forum-selection and arbitration clauses calling for out-of-state forums. *Mistubishi Motors Corp. v. Soler Chrysler-Plymouth, Inc.*, 723 F.2d 155, 158 (1st Cir. 1983). See *supra* notes 74-79 and accompanying text for a discussion of the case and others following it. Recently a federal district court in Puerto Rico invalidated a forum-selection clause in a dealership agreement calling for an out-of-state *judicial* forum because of the local statute. See *Triangle Trading Co., Inc. v. Robroy Indus., Inc.*, 952 F. Supp. 75, 80 (D. P.R. 1997). Thus, under Puerto Rican, and possibly First Circuit, law arbitration agreements apparently are held in higher regard than other forum-selection clauses.

158. See *Doctor's Assocs. v. Casarotto*, 517 U.S. 681, 685 (1996).

159. *Prima Paint Corp. v. Flood & Conklin Mfg. Co.*, 388 U.S. 395, 404 (1967); see also *Volt Info. Sciences, Inc. v. Board of Trustees*, 489 U.S. 468, 478 (1989) (quoting the passage from *Prima Paint* with approval).

160. When the decision is made to invalidate an arbitration agreement pursuant to a law of this type, an interesting question arises: Should the arbitration agreement be *entirely* voided, to allow for judicial consideration of the dispute between the parties, or should the court merely require that the arbitration agreement take place inside the franchisee's home state (thus complying with the state franchise law)? While this issue is outside the scope of this Note, a preliminary analysis suggests that in most cases the best alternative will be to invalidate the entire clause.

## V. CONCLUSION

This issue will be hotly contested in the near future. Arbitration clauses in franchise agreements are already common and are appearing with increasing frequency. At the same time, state laws restricting the application of these clauses are becoming more prevalent. Franchisors value arbitration clauses providing for a remote forum and are not likely to relinquish them in the face of a state law. Instead they will rely on the powerful Federal Arbitration Act to uphold the agreement. As this Note argues, however, these state laws can invalidate arbitration agreements without running afoul of the FAA.

Irrespective of the wisdom of state forum-selection laws, if enacted, these laws should be permitted to invalidate arbitration agreements because the laws are not preempted by the FAA. Arguably, these statutes, rules, and judicial decisions are overly paternalistic and will have the effect of invalidating provisions even in situations where franchisees understand the effect of the forum-

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In its best scenario, merely restricting arbitration to inside the franchisee's home state may uphold the intent of both the FAA and the state franchise law by first allowing arbitration to take place, and, second, protecting the franchisee against the burden of a remote forum. This alternative is not *required* by the FAA, however. At first glance, striking down an entire arbitration agreement pursuant to a state forum-selection law may seem to hold arbitration agreements to stricter scrutiny than judicial forum-selection agreements, because the state law invalidates both the place and type of resolution selected in the arbitration agreement, while only invalidating the place of resolution in the forum-selection agreement. On close inspection, however, these two clauses are not treated differently. The judicial forum-selection clause retains its type of resolution, that is, the ability to bring suit in court, only because the judicial consideration is always available. Thus the arbitration agreement is held to the same standard as other contracts, even if the entire arbitration clause is invalidated.

Requiring arbitration inside the franchisee's home state would also raise potentially serious practical and legal problems. In many cases, the arbitrator that the parties selected will be unavailable to arbitrate the case in a different state. Having the parties select another arbitrator may be practically impossible because the franchisee has already filed suit to avoid arbitration under the contract. The court could select an arbitrator, but this would create a great risk that the court would be enforcing a contract to which the parties never agreed.

Even if an arbitrator does not need to be selected, a court may not compel arbitration in a different forum than that selected by the agreement if the forum-selection aspect of the arbitration agreement is not severable from the agreement to arbitrate itself. For an arbitration agreement to be found severable, the forum-selection aspect of the agreement must be only a "minor consideration," while the agreement to arbitrate is the "essential term." *National Iranian Oil Co. v. Ashland Oil, Inc.*, 817 F.2d 326, 333-34 (5th Cir. 1987) (citing the RESTATEMENT (SECOND) OF CONTRACTS sec. 184-85). In typical franchise agreements with arbitration clauses providing for arbitration in the home state of the franchisor, the site of the arbitration is likely to be an important aspect of the arbitration agreement to the franchisor. Some franchisors may even prefer to have the entire arbitration clause voided, rather than pursue arbitration in an undesirable location and before an arbitrator the franchisor did not choose.

selection provision and the provision is the result of free bargaining.<sup>161</sup> The question addressed here, however, is not whether these laws are good policy, but whether they violate the FAA.

The proper resolution of this conflict is to allow the state law to invalidate the arbitration agreement. The FAA was never intended to preempt this type of state law, one that does not single out arbitration agreements, and is, instead, concerned with a distinct legitimate state interest. Indeed, allowing the FAA to preempt these state laws would produce perverse results, invalidating judicial forum-selection agreements while upholding arbitration agreements. Thus, allowing these state laws to invalidate arbitration agreements would follow Supreme Court precedent and comport with the congressional intent and the purpose of the FAA.

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161. See Levin & Morrison, *supra* note 5, at 118 (criticizing the *Kubis* rule because it makes "several assumptions concerning franchisors and franchisees which seem entirely out of date with current commercial realities"); see also Smith, *supra* note 117, at 1614-17 (criticizing the North Carolina statute because it is overbroad and unnecessary).

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