masuda funai

News & Types: Commercial, Competition & Trade Update

Seventh Circuit Strikes Down Another Arbitration Provision

11/10/2014

Practices: Litigation

In an earlier Update, we reported on a 7th Circuit Federal Court of Appeals case that struck down an arbitration provision. (*Deborah Jackson, et. al. v. Payday Financial, LLC, et. al.* 7th Circuit Court of Appeals, No. 12-2617, August 22, 2014) In the earlier case, the 7th Circuit struck down an arbitration provision providing for arbitration under the laws of the Cheyenne River Sioux Tribe. The court cited the high possibility of bias (since a principal of the other party was a member of the Tribe) and called the arbitration a "sham from stem to stern." The arbitration provision was part of a payday lending arrangement charging exorbitant interest rates to borrowers, which also weighed in the court's decision.

In another recent case just a week following, the 7th Circuit demonstrated that it will also strike down arbitration provisions in a commercial setting. (*Druco Restaurants, Inc. v. Steak N Shake Enterprises, Inc.*, 7th Circuit Court of Appeals, Case Numbers 13-3489, 13-3490, 13-3491 (consolidated), August 29, 2014)

Steak n Shake is the well-known casual restaurant franchisor offering hamburgers, milkshakes and other items. But some of its franchisees were dissatisfied, so they sued Steak n Shake. According to the plaintiff franchisees, since 1939, franchisees had the right to set their own menu prices and to participate in corporate pricing promotions at their option. All that changed in 2010, after a corporate takeover. From that point, franchisees were required to adhere to company pricing on their menus and to participate in corporate promotions. Franchisees were also required to purchase all of their products from a single distributor at a price negotiated by Steak n Shake. This cut into the franchisees' revenues. So three franchisees, located in Missouri, Georgia and Pennsylvania filed suit under their franchise agreements in federal court in Indiana (the agreed forum in some of the franchise agreements).

Wait a minute, said Steak and Shake. Why don't we arbitrate? After all, the franchise agreement provides for arbitration. For this purpose, one month after the litigation was filed, Steak n Shake adopted an arbitration policy requiring the franchisees to engage in nonbinding arbitration at Steak n Shake's request. But the franchisees successfully fought arbitration. So why wouldn't the court enforce the arbitration agreement? After all, don't courts routinely enforce arbitration provisions between businesses?

The franchise agreements contained different dispute resolution provisions. One provided for venue and jurisdiction in Missouri. Others provided for jurisdiction and venue in Indiana. All but one of the franchise agreements contained a clause permitting Steak n Shake to "institute at any time a system of nonbinding arbitration or mediation." Applying Indiana law, the district court refused to enforce the provision and the 7th Circuit Court of Appeals upheld that refusal.

Judge Rovner of the 7th Circuit cited the low standards for a court to compel arbitration. To compel arbitration a party only needs to show a) an agreement to arbitrate, b) a dispute within the scope of the arbitration agreement and c) a refusal by the other side to arbitrate.

But was there an agreement to arbitrate? The court called this "illusory." "An illusory promise is a promise which by its terms makes performance entirely optional with the promisor." Since arbitration was entirely at the option of Steak n Shake, the court found the arbitration clauses illusory.

> ". . . Steak n Shake was free to exercise or not exercise the arbitration clause at its whim. The company also retained the discretion to determine the circumstances and procedures under which arbitration may take place, including deciding which types of claims will be subject to arbitration. Indeed, nothing in any franchise contract precludes Steak n Shake from instituting a new system of nonbinding arbitration at any time, changing the rules and procedures as the company sees fit."

But, as we all know, agreements commonly contain option provisions, permitting one party to act (or decline to act) at its sole option. What is the difference here? The difference, according to the court, is that a valid option contract "depends upon intent to be bound and definiteness of terms." Here, some terms were missing or indefinite. The claims that would be arbitrated and the claims that would not were at Steak n Shake's sole discretion. So franchisees would not know, ahead of time, if any potential dispute would be arbitrated or not. The court also noted that Steak n Shake tried to apply its arbitration policy to pending litigation, which clearly disturbed the court. There was also nothing in the franchise agreement about the specific arbitration forum or arbitration rules and procedures (although Steak n Shake tried to correct this in its policy adopted after the litigation started).

So a franchisee, contemplating a dispute with Steak n Shake, would be left to wonder if the dispute would be resolved in arbitration or litigation. The franchisee could start litigation (as the franchisees did in this case) but would not know if Steak n Shake would later adopt a policy and move the case to arbitration. The franchisee would also not know, in advance, the arbitration organization, the location, and the rules and procedures in the arbitration. Therefore, the 7th Circuit struck down the arbitration provision.

Are arbitration provisions at risk? The answer is almost certainly no. The court repeatedly cited the ability of parties to enter into arbitration agreements and the courts' ability (and desire and willingness) to require the parties to arbitrate as they agreed.

But two recent cases from the 7th Circuit cannot be ignored. They are probably limited to their unique circumstances. The factors which put these arbitration provisions at risk included:

- In the *Payday Financial* case, the consumer context in which individuals were borrowing at exorbitant interest rates;
- Also, in the *Payday Financial* case, the concern with the neutrality of the arbitration organization and the "sham" nature of the arbitration proceedings; and
- In the *Steak n Shake* case, giving one party (especially the party with superior bargaining power) the ability to unilaterally institute an arbitration policy, even with respect to pending litigation, with no information on the arbitration forum, rules or procedures.

So the two cases can tell us what arbitration provisions might be at risk. But the cases should not prevent parties, especially commercial parties, from agreeing to utilize arbitration in their disputes.