Contracts Tea no. 7 (September 2011)

National

Appeals court says mandatory arbitration for warranty disputes is unsound.

The United States Court Of Appeals for the Ninth Circuit found for the plaintiff/consumer in *Diana Kolev v. Porsche Cars North America*, decision No. 09-55963, filed September 20, 2011, opinion by Judge Reinhardt. The dissenting judge, Judge Randy Smith, cited the Supreme Court's *AT&T Mobility v. Concepcion* decision that affirmed an arbitration clause under the Federal Arbitration Act.[1]

When her pre-owned Porsche automobile developed serious mechanical problems during the warranty period and the dealership refused to honor her warranty claims, Diana Kolev sued, alleging breach of implied and express warranties under the Magnuson-Moss Warranty Act ("MMWA"), and breach of contract and unconscionability under California law. The district court granted the dealership's petition to compel arbitration pursuant to the mandatory arbitration provision in the sales contract. The arbitrator resolved most of the claims in favor of the dealership and the district court confirmed the arbitration award. Kolev appealed.

Kolev's principal argument was that the MMWA, 15 U.S.C. § 2301 *et seq.* (2000) – as construed by the Federal Trade Commission ("FTC") - bars pre-dispute mandatory binding arbitration provisions covering written warranty agreements.

The Court, in reversing the trial court's decision to enforce arbitration clause, noticed that the MMWA is silent on the issue and that the FTC had a legitimate power to interpret the Act.[2] The Court held that the FTC's construction was reasonable and should be adopted because in line with MMWA's history and purpose, and because longstanding (more 35 years) and consistent. The Court rejected the argument that the FTC's construction would be unreasonable in light of the Supreme Court's repeated holdings that Congress established a "liberal federal policy favoring arbitration agreements" in the Federal Arbitration Act ("FAA"). The Court cited the Supreme Court decision of *Shearson/Am. Express Inc. v. McMahon*, 482 U.S. 220 (1987) holding that the FAA established a *rebuttable* presumption in favor of arbitration. Congress could override the FAA in any later statute by adopting "a contrary congressional command." 482 U.S. at 226.

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[1] 563 U.S. ___ (2011) issued April 27, 201. Contracts Tea no. 3.

[2] Congress delegated a rule making authority to the FTC under 15 U.S.C. § 2310(a)(2).

The Court of Appeals stated that "the 1975 Magnuson-Moss Warranty Act is different in four critical respects from every other federal statute that the Supreme Court has found does not rebut the FAA's pro-arbitration presumption, including the Sherman Antitrust Act of 1890, the Securities Act of 1933, and the Securities Exchange Act of 1934."[3] In conclusion, the Ninth Circuit, adopting the FTC's construction of the MMWA, held that "written warranty provisions that mandate pre-dispute binding arbitration are invalid under the MMWA and that the district court therefore erred in enforcing Porsche's warranty clause by compelling mandatory arbitration of Kolev's claims."

The dissent characterized the majority's opinion as a "departure from Supreme Court precedent, the prevailing view of our sister circuits, and applicable statutes."

The majority gives four reasons why the situation under the MMWA (see our footnote no. 3) is different from other situations in which the Supreme Court has sustained arbitration provisions. I think that those reasons are quite persuasive. However, should the Congress want to favor arbitration also in these types of controversies, Congress is free to override the interpretation given by the FTC and amend the MMWA to allow compulsory arbitration.

South Carolina

In noncompetition agreements reasonableness is the key for enforcement. A step-down clause can save a non-competition agreement that a court considers too broad. Is the enforcement of step-down clauses a sound policy anyway?

On September 14, 2011, in *Team IA, Inc. v. Lucas*, No. 4889, an employment non-compete and non-solicitation case, the South Carolina Court of Appeals held that summary judgment was premature and sustained a step-down clause, i.e. an alternative restriction that is planned to be effective if a court finds that the broader restriction is too broad.

Team IA conducted business in the microfilm, data entry, software, hardware, consulting, and related services industries. In April of 2001, Team IA hired Lucas as a sales representative.

[3] First, unlike the other statutes, an authorized agency construed the MMWA to bar pre-dispute mandatory binding arbitration. Second, only for the MWWA Congress said something about informal, non-judicial remedies, and do so in a way that would bar binding procedures such as mandatory arbitration (*See* 15 U.S.C. § 2310(a)(2)). Third, in the MMWA alone did Congress explicitly preserve, in addition to informal dispute settlement mechanisms, a consumer's right to press his claims under the statute in civil court. *See* 15 U.S.C. § 2310(a)(3)(C). Fourth, only the MMWA sought as its primary purpose to protect consumers by prohibiting vendors from imposing binding, non-judicial remedies.

The parties signed an employment agreement that contained a nonsolicitation agreement[4] and a covenant not to compete.[5]

Lucas resigned from Team IA in February of 2009 and contacted all but one of the customers with whom he had worked while in Team IA. Within one week of his resignation, Lucas established and became part owner and operator of 5 Point Solutions, LLC, a company that performed services similar to Team IA's services. Two of Team IA's customers pulled their projects from Team IA and gave them to 5 Point Solutions. Team IA sued Lucas on various cause of actions alleging inter alia that Lucas breached the terms of his employment agreement. Lucas filed a motion for partial summary judgment on the breach of contract action. The court granted it because (1) the restricted territory set forth in the non-competition clause was overly broad as Team IA did not have clients in three of the four states listed, and (2) the non-solicitation provision was unenforceable as it prohibited Lucas from accepting business from unsolicited customers of Team IA. Team IA appealed. The Court of Appeals reversed and remanded.

Citing to *Rental Uniform Serv. of Florence, Inc. v. Dudley* (301 S.E.2d 142, 143 (1983)) the Court of Appeals reminded that:

> A covenant not to compete will be upheld only if it is: (1) necessary for the protection of the legitimate interest of the employer; (2) reasonably limited in its operation with respect to time and place; (3) not unduly harsh and oppressive in curtailing the legitimate efforts of the employee to earn a livelihood; (4) reasonable from the standpoint of sound public policy; and (5) supported by valuable consideration.

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[4] Non-Solicitation Agreement: 1) Employee agrees … that while employed by Employer and for a period of twelve (12) months following termination of Employee's employment with Employer … that he will neither directly [n]or indirectly… solicit, attempt to solicit, sell to, or attempt to sell to any Employer CUSTOMER any products or services that are competitive with Employer products or services.

[5] Covenant Not to Compete

1) … [E]mployee agrees that … while employed by Employer and for twelve (12) months immediately following the resignation or termination of his employment … Employee shall not, directly or indirectly… within the geographical territory (hereinafter, the "RESTRICTED TERRITORY") set forth below, solicit, attempt to solicit, sell, or attempt to sell, provide, or attempt to provide COMPETING SERVICES …

The Court of Appeals also reminded how South Carolina law disfavors non-compete covenants[6] and how as a consequence "[a] restriction against competition must be narrowly drawn to protect the legitimate interests of the employer." *Faces Boutique, Ltd. v. Gibbs*, 455 S.E.2d 707, 708 (Ct. App. 1995). The key, reminded the Court of Appeals, is reasonableness.[7]

> A geographic restriction is generally reasonable if the area covered by the restraint is limited to the territory in which the employee was able, during the term of his employment, to establish contact with his employer's customers. *Rental* Uniform, 301 S.E.2d at 143. *Standard Register Co. v. Kerrigan*, 119 S.E.2d 533, 535, 544 (1961)).

The interesting part of the sentence, however, is in the enforcement of the step-down clause. Here the parties agreed that

> RESTRICTED TERRITORY shall consist of the entire continental United States. In the alternative, and only if such territory is deemed by a court or other proceeding to be unreasonable or otherwise invalid or unenforceable, then … South Carolina, North Carolina, Georgia, and Alabama.

The Court of Appeals, while striking down the nationwide limitation, upheld the step-down clause:

> The nationwide territorial restriction contained in the non-competition provision at issue was overly broad on its face. However, we conclude the alternative territorial restriction contained in the parties' original agreement (South Carolina, North Carolina, Georgia, and Alabama) would remain valid and

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[6] "Restrictive covenants not to compete are generally disfavored and will be strictly construed against the employer." *Rental Uniform, id.*

[7] Agreements not to compete, while looked upon with disfavor, critically examined, and construed against any employer, will be upheld as enforceable if such agreement is reasonable as to territorial extent of the restraint and the period for which the said restraint is to be imposed. *Almers v. S.C. Nat'l Bank of Charleston,* 217 S.E.2d 135, 136 (1975).

> enforceable to the extent it is not overly broad after further development of the facts.[8]

In a "no blue-pencil" jurisdiction,[9] i.e. a jurisdiction in which courts do not rewrite overly broad non compete clauses (they simply strike them down), the insertion of a step down clause seems to be a useful device to save an agreement.[10]

But what if the step-down clauses gain a generalized ground in our courts? What if parties fear for example that they are inserting an unconscionable clause? Think about a classic case like *Williams v. Walker-Thomas Furniture Co.* 350 F.2d 445 (D.C. Cir. 1965)[11] in which the furniture shop inserted a clearly unconscionable clause that allowed the shop to replevy *all* the furniture sold to the customer in the course of many years in case the customer defaulted in one installment for one of the pieces of furniture.[12] Would it be fair to let the parties insert something: well, if the replevy of all the pieces of furniture is

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[8] So, is this alternative territory valid or was it invalid because it is overly broad? It is a question on fact impinging on the nature of Lucas's assigned territory and contact with customers/potential customers. The Court of Appeals held that further inquiry was needed; therefore, it reversed and remanded.

[9] South Carolina is probably a "no blue-pencil" jurisdiction. See Supreme Court decision Poynter Investments v Century Builders, 694 S.E.2d 15 (S.C.,2010):

> [I]n South Carolina, the restrictions in a non-compete clause cannot be rewritten by a court or limited by the parties' agreement, but must stand or fall on their own terms. We hold, therefore, that the trial judge erred in rewriting the territorial restriction in the parties' contract.

The issue is somewhat unclear however because there are cases suggesting the availability of blue-penciling of divisible covenants that the Court did not consider in *Poynter Investments*.

[10] For a comment on this, see Kenneth J. Vanko, Step-Down Clauses May Be Important In Blue-Pencil States (Team IA, Inc. v. Lucas), available at http://www.non-competes.com/2011/09/step-down-clauses-may-be-important-in.html

[11] Ignore for the purpose of this example that the clause contained in the contract of *Williams v. Walker-Thomas Furniture is* outlawed by the Credit Practices Rules, effective March 1, 1985 (16 C.F.R. Part 444).

[12] "The amount of each periodical installment payment to be made by [purchaser] to the Company under this present lease shall be inclusive of and not in addition to the amount of each installment payment to be made by [purchaser] under such prior leases, bills or accounts; *and all payments now and hereafter made by [purchaser] shall be credited pro rata on all outstanding leases, bills and accounts* due the Company by [purchaser] at the time each such payment is made."

considered unconscionable, then the parties agree that the furniture shop can replevy the pieces of furniture for which the breach occurred?

I am skeptical because step-down clauses encourage overdrafting and lead to the clauses having an *in terrorem* effect. For sure, I would not enforce the clause if there was evidence that the broadest clause was clearly unreasonable. In the particular case of *Team IA, Inc. v. Lucas,* I do not see any justification for the entire continental US, so my opinion is that the entire clause should be invalid.

INTERNATIONAL

Is the European Commission's Feasibility Study a (stumbled) step towards a unified European contract law? Let's wait and see the future bill.

In April 2010 the European Commission appointed an expert group and on July 1, 2010 the Commission published a Green Paper with seven policy options to advance the harmonization of European law.[13]

On May 2011 the European Commission published (and asked for comments on) a "Feasibility Study on a European Contract law for Consumers and Business" ("Feasibility Study"), a document that covers primarily the sale of goods and services. The document will probably become a European regulation that will implement an "optional instrument" in each member state, i.e., a uniform set of rules that consumers will have the ability to opt to, instead of the national rules. In particular, the Commission announced that in October 2011 it will present a bill, probably seeking an EU regulation.

The Feasibility Study is based on the European Draft Common Frame of Reference ("DCFR") but unlike the latter, only covers general rules on formation of contracts, rules on sales contracts, and rules on service contracts. The DCFR was an academic text that was the result of more than 25 years' collaboration of jurists from all EU jurisdictions.[14] It had the formal structure of a civil code (being divided in books, chapters, sections and articles) and it was very broad: it covered general provisions, contracts and other juridical acts, obligations and rights, benevolent intervention in another's affairs (similar to emergency

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[13] See the Expert Group's study and the Commission's Green paper at http://ec.europa.eu/justice/contract/index_en.htm

[14] It began in 1982 with the constitution of the Commission on European Contract Law (CECL) and was furthered by the establishment of the Study Group in 1998 and the Acquis Group in 2002. See in the website of the EU: *Draft Common Frame of Reference.* Outline Edition.

situation in American Common law), non-contractual liability arising out of a damage caused to another, and unjustified enrichment, acquisition of ownership of movables and loss thereof, proprietary security rights, trusts. It was inspired by the principles of freedom, security, justice and efficiency.

The Feasibility Study is much more restricted. The content is the following: Part I contains introductory provisions, Part II provisions on "Making a binding contract", Part III provisions on "Assessing what is in the contract", Part IV provisions on "Obligations and remedies of the parties to a sales contract", Part V "Obligations and remedies of the parties to a related services contract", Part VI "Damages, stipulated payments for non-performance and interest", Part VII "Restitution", Part VIII "Prescription".[15]

While many have appreciated the intention of the European Commission implementing a program of unification of the European law, the Feasibility Study has received more criticism than favour because seen as too limited in scope and seen as a duplication (with differences however) of the CISG. In addition, according to many it risks to conflict with the proposed Consumer Rights Directive.[16] This is the position of the German Bar for example.[17] Some others simply criticize the document because inconsistent with the principle of freedom of contract.[18]

China's recent enactments to fight corruption

The Foreign Corrupt Practices Act of 1977 (FCPA) (15 U.S.C. §§ 78dd-1, *et seq.)* is not the only concern that an American company operating abroad should have. Besides the FCPA provisions, American companies operating abroad should be compliant with foreign provisions regulating what is an allowed gift and what, on converse, constitutes bribery.

As many other countries, China has enacted anti-corruption regulation. The anticorruption regulation is scattered in many pieces of legislation. While some academics had proposed that China should enact a comprehensive legislation to fight corruption, China

[15] See on line for the full text of the Feasibility study.

[16] http://ec.europa.eu/consumers/rights/cons_acquis_en.htm

[17] Position of the Bundesrechtsanwaltskammer (The German Federal Bar) on the European Commission's feasibility study on a European Contract Law available at http://www.brak.de/zur-rechtspolitik/stellungnahmen-pdf/stellungnahmen-europa/2011/juni/position-of-the-brak-2011-38.pdf.

[18] See http://www.cliffordchance.com/publicationviews/publications/2011/05/european_contractlawdraftcodepublished.html

has recently enacted only several regulations that represent important efforts to fight corruption.

In particular:

(i) On July 17, 2010, a new rule concerning the duties for government workers to report their investments, incomes, and assets and that of their family members.[19]

(ii) On April 30, 1995, the General Office of the State Council issued a "gift register regulation for workers of government or party"[20] in order to fight the practice of gift-giving to Chinese government employees.

iii) On February 25, 2011, in the nineteenth session of the eleventh National People's Congress Standing Committee, a modification of Article 164 of the Criminal Law has been passed. The amendment, promulgated on May 1st 2011, introduced a new paragraph to the criminal statute of Article 164. This new paragraph punishes "Whoever, for the purpose of seeking unjustified business interests, gives money or property to any foreign party performing official duties or officials of international public organizations." This provision constitutes the Chinese version of the FCPA.[21]

Cultural differences constitute a possible trap for the unaware.

Everybody knows that: when dealing with a foreign party, we should not assume that everything is like it is in the United States. This is true in law and in culture. And both play an almost equal part in business negotiations.

The importance of being familiar with the language of the other party is obviously mandatory when the negotiations are not conducted in English, but this is also true if the negotiation is conducted in English. Because the other party comes from another language/legal background, if parties are not particularly careful, misunderstandings are not only possible but inevitable (think about the difference between translation and adaptation). But here we want to speak about cultural differences.

Every lawyer that deals with foreign parties has his or her stories to tell. From different roles of lawyers and notaries in other countries to public authorities' attitudes towards law enforcement, from dress code to time of the meeting, from acceptance of invitations to handling of business cards.

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[19] See http://www.bbc.co.uk/news/10595981.

[20] http://www.lehmanlaw.com/resource-centre/faqs/criminal-law/what-are-chinas-corruption-laws.html

[21] The corruption of Chinese government employees is sanctioned by Articles 389 and 390 of the Chinese Criminal Law.

If you have missed it, interesting enough is the report of the lecture given on August 5, 2011, by Olga M. Pina at the ABA Annual Meeting 2011 held in Toronto.[22]

For further information, send an email to info@nathancrystal.com.

[22] Cross-Cultural Legal Transactions Can Easily Get Lost in Translation, available at http://www.abanow.org/2011/08/cross-cultural-legal-transactions-can-easily-get-lost-in-translation/