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Practical Alternates to Termination

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I. Why Consider Dispute Resolution Rather Than Litigation in the Franchise Context

This paper provides an overview of issues to be considered when disputes arise in the context of franchising relationships from both the franchisor and franchisee perspectives, with a focus on various alternative dispute resolution (ADR) options and strategies. Franchisor-franchisee relationships are typically mutually beneficial, and in many instances one or more forms of ADR – as opposed to litigation – will help to either preserve such relationships and the advantages arising therefrom or help facilitate a smooth termination process. Given that the franchisor-franchisee relationship is based primarily on the franchise agreement, disputes typically relate to, or flow from, the parties' contractual rights and obligations.

When outside and in-house franchise attorneys learn of a potential dispute, their first task should be to identify their client's goals. Oftentimes, the parties' goals are aligned. Both the franchisor and franchisee will prosper when the franchise system grows and the franchisee maintains its compliance and revenue stream. Indeed, a key factor contributing to a franchise system's success is its franchisee's ongoing successful operation.

But even where the parties' goals appear to conflict, ADR can encourage communication by closing the gap between their perceived differences. Hence, most franchise agreements contain dispute resolution provisions mandating at least one form of ADR – negotiation, mediation, or arbitration. In cases where the agreement does not include such provisions, the parties may voluntarily – and frequently do – submit to mediation or arbitration after a dispute arises. Moreover, ADR is often ordered by the court after litigation has been initiated. Whether voluntarily undertaken, or mandated by contract or the court, ADR can be an invaluable tool for franchisors and franchisees alike.

A. Common Disputes Arising in the Franchise Context

1. Registration and disclosure issues

The Franchise Rule promulgated by the Federal Trade Commission (FTC), 16 C.F.R. Parts 436 and 437, requires franchisors to provide all potential franchisees with a disclosure document containing twenty-three specific items of information about the franchise. Required disclosures include, among other things, background information on the franchisor, costs associated with the business, legal obligations of the parties, and audited financial information. State legislatures have also passed franchise registration and/or disclosure statutes.

These statutes provide franchisees with a private right of action against franchisors, unlike the FTC's Franchise Rule, which only permits enforcement action by the FTC.

While states' registration and disclosure statutes vary, each generally prohibits the sale or offer of a franchise to a prospective franchisee unless the franchisor has followed proper registration requirements (and, in turn, has made certain disclosures). Thus, a franchisor's failure to do so may give rise to a variety of claims by franchisees seeking rescission of their franchise agreement and/or damages. Similarly, during the course of negotiations, franchisors may make representations to prospective franchisees beyond those contained in the disclosure statement, such as statements regarding the company's anticipated prospective financial performance. A false statement by the franchisor that is reasonably relied upon by the prospective franchisee may give rise to a common law misrepresentation or fraud claim.

2. Contract-related disputes

The franchise agreement is an expansive document that imposes a number of obligations on both parties. Therefore, a high percentage of disputes in the franchise context arise from the franchisor and franchisee's contractual relationship. Common disputes involve training and support, system requirements and brand standards, product and pricing issues, encroachment, transfer issues, and termination.

Most franchise agreements set forth the franchisor's obligations with respect to training and operational support. Where the franchisor fails to provide support as the agreement requires, and the franchisee's performance suffers as a result, the franchisee may assert a claim for breach of the franchise agreement. On the other hand, a franchisor may consider taking action where a franchisee fails to comply with specific requirements and brand standards in the franchise agreement.[1] For example, franchisors typically set health and safety standards for franchisees, and a franchisee's failure to adhere to such standards could result in damage to the brand. In addition, franchisees are required to pay the franchisor compensation for products or services, royalties, and advertising fees. A franchisee's failure to do so will likely give rise to a claim by the franchisor for monetary damages.

Encroachment occurs when a franchisee is granted an exclusive territory and the franchisor subsequently grants franchise rights within that territory to another franchisee. In these circumstances, the aggrieved franchisee may seek relief through provisions of the franchise agreement itself or, depending on the state, via statute. Encroachment may also give rise to claims for breach of the

[1] A franchisee's breach of the franchise agreement will often also result in the franchisor taking steps to demand a cure of the breach via a notice of default or a termination of the agreement.

implied covenant of good faith and fair dealing and tortious interference with prospective business advantage.

Franchise agreements typically permit franchisees to transfer their franchise to third parties subject to the franchisor's approval, and contractual restrictions on transfers tend to be interpreted narrowly. Thus, a dispute may arise where a franchisor unreasonably withholds its consent to a proposed transfer.

Finally, a franchisor's wrongful termination or nonrenewal of the franchise agreement will likely bring about contractual and statutory claims by the franchisee. A franchisor may seek termination (in-term) or nonrenewal (after the term has expired) when a franchisee defaults under the franchise agreement. Nevertheless, both the franchise agreement and certain state statutes usually distinguish between defaults that are curable and those that are not. Disputes of this nature are particularly well-suited to be resolved through ADR given the inevitably varied interpretations of certain provisions of the franchise agreement, and the discretion granted to the franchisor to either provide for a cure period or waive the franchisee's default.

Where both parties stand to benefit from a continued relationship, many of the disputes described above are best addressed, at least initially, through ADR.

3. Trademark disputes

By way of the franchise agreement, the franchisor grants the franchisee a license to utilize its trademark(s). Disputes may therefore arise in the trademark context where the franchisor lawfully terminates the franchisee's license, and the franchisee continues exploiting trademarks owned by the franchisor. Specifically, the franchisee may be subject to liability for trademark infringement under the Lanham Act, 15 U.S.C. 1114(1)(a), which states the following:

> Any person who shall, without the consent of the registrant-- (a) use in commerce any reproduction, counterfeit, copy, or colorable imitation of a registered mark in connection with the sale, offering for sale, distribution, or advertising of any goods or services on or in connection with which such use is likely to cause confusion, or to cause mistake, or to deceive; or (b) reproduce, counterfeit, copy, or colorably imitate a registered mark and apply such reproduction, counterfeit, copy, or colorable imitation to labels, signs, prints, packages, wrappers, receptacles or advertisements intended to be used in commerce upon or in connection with the sale, offering for sale, distribution, or advertising of goods or services on or in connection with which such use is likely to cause confusion, or to cause mistake, or to deceive . . . shall be liable in a civil action by the registrant . . . .

Disputes regarding trademark violations and related damage to the brand trademarks may arise even when the franchisor and franchisee have an otherwise valid franchise agreement, such as when a franchisee misuses a trademark or uses it in a way that damages the validity or effectiveness of the trademark. To a franchisor, such a violation may be more harmful than unauthorized use, as there may be an argument that such misuse was authorized by the franchisor.

While many dispute resolution provisions in franchise agreements carve out claims under the Lanham Act from mandatory ADR, the parties may nonetheless voluntarily mediate or arbitrate trademark-related disputes.

B. Franchisor Perspective

The franchisor should approach disputes with individual franchisees with the system's best interests in mind. At first blush, a franchisor may be inclined to immediately pursue litigation as a means of sending a message or protecting the brand. But ADR offers a number benefits to franchisors, each of which should be carefully evaluated, that can send a similar message and equally protect the brand without the costs of full blown litigation and without possible negative effects on future franchise sales.[2]

The complexities associated with franchise litigation can quickly drive up costs irrespective of the nature of the dispute. Electing ADR can eliminate or significantly reduce such costs, such as those associated with discovery. While franchisors often have the resources to finance litigation, such resources are often better spent improving the brand and growing the system.

The potential system-wide adverse effects of litigation can strongly favor some form of ADR as an alternative to litigation. Given that ADR is not precedential, the impact of any unfavorable decision against the franchisor is less likely to ripple through the system and thereby prompt additional claims when it occurs in the context of ADR. Litigation can also result in negative publicity with regard to the franchisor. Thus, the franchisor's ultimate goal of growing the system may be inhibited by litigation and severed relationships with franchisees. Similarly, confidentiality considerations may warrant ADR. While pending litigation must be publically-disclosed under federal and/or state laws, ADR will usually remain confidential.

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2. Franchisors should carefully consider the message that could be sent to compliant franchisees and prospective franchisees regarding its willingness to litigate.

ADR may be the best option where the franchisor is unlikely to collect damages even if successful in litigation. Take, for instance, a dispute arising from the franchisee's failure to pay royalties or other fees. A negotiated compromise through which the franchisor receives a portion of the amount owed can certainly be preferable to a larger but uncollectable award obtained after years of costly litigation.

C. Franchisee Perspective

A franchisee's ultimate goal is to maximize the value of its investment. Cost and efficiency considerations, therefore, may encourage a franchisee to pursue ADR as opposed to litigation when disputes with its franchisor arise.

When evaluating its dispute resolution options, a franchisee should first consider the amount at issue. As discussed, franchise litigation can quickly become costly. Where the financial stakes are low – such as with minor disclosure and operational support issues – negotiation led by the franchisee's principal, or perhaps mediation, might be the best choice. Franchisees will typically have less economic and legal resources than franchisors and, thus, taking advantage of these informal ADR options can help level the playing field. Where the stakes are higher, however, franchisees may desire a concrete and final resolution. These more significant conflicts may arise, for example, in the context of wrongful termination. In such circumstances, arbitration may be the best option.

In addition to the potential cost and efficiency benefits, parties electing ADR have more discretion with respect to forms of relief available as compared to those engaging in litigation. Both negotiation or mediation can provide franchisees with the flexibility to craft acceptable resolutions that would not otherwise be available. These methods may be particularly appealing to franchisees as an alternative to leaving significant decisions affecting their investment in the hands of a disinterested third party. In a similar regard, parties electing mediation or arbitration can select neutral third parties with industry knowledge. Mediators and arbitrators with franchise experience may be better in tune with, and sympathetic to, the challenges faced by many franchisees.

In view of the significant investment made by the franchisee necessary to enter the system, a continued business relationship with the franchisor is often – but not always – the preferable outcome from the franchisee's perspective. ADR is more likely than litigation to facilitate such a continued relationship.

By utilizing ADR, a franchisee can avoid the stress and anxiety associated with litigation. As discussed, litigation can be time-consuming and burdensome as a result of paper discovery, depositions, and trial, all of which can take a toll on the litigants emotionally. Avoiding these steps can prevent wasted time and resources and allow franchisees to devote this time to business-related efforts. Moreover, ADR can provide an opportunity for the franchisee to "tell its story," whereas a party electing litigation may never step foot in court. Frequently, the franchisee simply wants to get the franchisor's attention, especially in circumstances where a franchisee believes it has been neglected by the franchisor. Perceived disputes may resolve themselves after a franchisee has had an opportunity to present its grievances to the franchisor through ADR.

II. Understanding Your Client's Business Goals

Either before or concurrent with evaluating the legal merits of a franchise dispute, counsel should also consider their client's business objectives and alternative paths to those objectives. Many clients will contact their attorney with the intent to file suit immediately. This approach, of course, is not always in the client's best interest.

ADR may help bring the client's goals into focus, and even identify areas where such goals are aligned. Most critically, the parties should determine as early as possible whether the conclusion of the dispute will involve the franchisee remaining in or exiting the system. Either option may be appropriate depending on the nature of the dispute.

A. Remaining in the System

Because both franchisors and franchisees invest significant time and resources at the outset of their relationships, efforts should generally be made to reach resolutions to conflicts that involve the franchisee remaining in the system. The obvious first question to ask is whether the parties' differences are reconcilable. Either way, ADR can encourage a prompt solution and avoid the prospect of wasted investments. Negotiation and mediation are well suited to parties who want to maintain an ongoing business relationship. For instance, through either of these methods, the parties may be able to re-negotiate, or compromise with respect to interpretation of, terms in the franchise agreement giving rise to the dispute as an alternative to initiating costly litigation.

B. Exiting the System

If both parties have unequivocally concluded that they are unable to continue their business relationship, their attorneys must determine how to sever the franchisor-franchisee relationship in the most efficient and cost-effective manner possible. ADR can help facilitate a mutually-beneficial deal through which parties end their business relationship with low or moderate transaction costs. Ideally, under these circumstances, the parties or their counsel will negotiate the terms of the termination themselves and the parties will go their separate ways in a structured and systematic way that avoids damages associated with the very public and loud shuttering of a business overnight.

From the franchisor's perspective, a variety of options may come to light through ADR. For instance, it may be in the best interest of the franchisor to assist the franchisee in selling the franchise to a third party. Indeed, the franchisor may be in a better position than the franchisee to identify an acceptable buyer. Similarly, where no third-party buyer is identified, the franchisor may elect to purchase the franchise directly from the franchisee. An agreement to pursue one of these exit strategies will of course also benefit the franchisee.

III. Options Short of Litigation

A. Negotiation

Negotiation between the franchisor and franchisee can be an effective and inexpensive method of dispute resolution. Thus, the parties should always consider utilizing negotiation as an initial option when a conflict arises. As with other methods of dispute resolution, negotiation may bring to light potential solutions not previously considered as a result of poor communication. Unlike other options, however, negotiation can be attempted at a minimal cost. Once the parties sit down at the negotiating table and express their positions with regard to a given issue, potential solutions not previously considered can emerge. While the parties may find it helpful to involve outside counsel at the negotiation stage, oftentimes direct negotiations are successful. Whether the parties negotiate directly or through counsel, the participants should keep a number of considerations in mind as they proceed with negotiations.

It is critical that the parties' representatives adequately prepare in advance of their negotiation session. If negotiating directly, have the parties' representatives identified their respective goals? If negotiating through counsel, have counsel inquired into and become familiar with their client's goals? Those with an in-depth understanding of the relevant facts and issues will enter the negotiations with a significant advantage.

Effective negotiators will also listen to and analyze the opposing side's positions and arguments and set reasonable expectations for themselves or their clients. During the course of negotiations, previously unconsidered approaches often come to light as a result of critical listening. Likewise, parties engaging in negotiation must recognize that a successful outcome will undoubtedly involve some degree of compromise.

B. Mediation

Mediation refers to direct negotiation between parties to a dispute facilitated by an impartial mediator. Parties usually submit their dispute to mediation voluntarily, unless the franchise agreement contains a dispute resolution provision that provides otherwise (discussed in further detail below). Given that the primary goal of mediation is to encourage settlement, the decisions of the mediator are non-binding. Mediation is typically confidential, although franchisors will be required to disclose mediation under the federal

Franchise Rule when that mediation leads to the settlement of a pending litigation. Where litigation has not yet been initiated, however, the private nature of mediation gives the parties flexibility when negotiating, perhaps even encouraging unconventional outcomes and remedies. As an example, a confidential settlement may include both a financial and non-financial component.

Mediation is relatively quick, efficient, and cost-effective, especially as compared to litigation. Mediation sessions last from one to several days and require minimal preparation. While the mediator may recommend that the parties exchange certain information, the mediator has no power to compel discovery from either party. To compensate for the limited disclosure, the mediator often meets with each party separately and solicits relevant information on a confidential basis. This method can assist the mediator in proposing reasonable and potentially acceptable settlement options and figures to both parties.

Additionally, mediation fosters communication between parties and may assist in preserving a continued working relationship between the franchisor and franchisee. Similarly, it may help the parties to better identify their bottom-line interests and goals. However, mediation may not be effective where only one party has incentive to promptly reach a settlement, as either party has the ability to block mediation given the lack of a third-party decision maker. Mediation is best for parties that have made significant investments to develop their relationship and that view each other as valuable assets.

Mediation also provides the parties the opportunity to select a mediator with industry knowledge. The parties can themselves select an experienced franchise attorney in private practice, or take advantage of programs such as the National Franchise Mediation Program (NFMP). The NFMP, which is administered by the International Institute for Conflict Prevention & Resolution, is led by members of the franchise community and tailored specifically to the franchise industry. A well-qualified mediator with industry-specific experience will understand the issues giving rise to the parties' conflict and, as such, be well-suited to propose viable, mutually-acceptable resolutions.

C. Arbitration

Arbitration refers to a binding dispute resolution method conducted by an appointed neutral third party. As with mediation, many franchise agreements require parties to arbitrate, instead of litigate, certain disputes. Unlike mediation, however, a party cannot be compelled to submit a dispute to arbitration unless it has expressly agreed to do so. Including an arbitration provision in the franchise agreement has certain advantages and disadvantages.

While arbitration may be more efficient and less costly than litigation, this is not always so, as both forms of dispute resolution share similar characteristics. For instance, the parties to an arbitration proceeding must exchange discovery, although such discovery is usually more narrowly-tailored to the disputes at issue than formal discovery conducted in accordance with federal or state discovery rules. Depending on the particular dispute, a given party may view this limit on discovery as an advantage or a disadvantage. Other costs associated with arbitration include filing fees, arbitrator fees, and attorneys' fees. Depending on the terms of the parties' arbitration clause, these costs may be divided evenly or assessed against the non-prevailing party. Nevertheless, arbitration is less formal than litigation in that the arbitrators are not bound by any evidentiary or procedural rules. Arbitration is also non-public, non-precedential, and not subject to appeal (see 9 U.S.C. § 10(a)).

The Federal Arbitration Act (FAA), 9 U.S.C. § 1, et seq., applies to provisions in the parties' franchise agreement that relate to arbitration. The FAA mandates that

> [a] written provision in . . . a contract evidencing a transaction involving commerce to settle by arbitration a controversy thereafter arising out of such contract or transaction, or the refusal to perform the whole or any part thereof, or an agreement in writing to submit to arbitration an existing controversy arising out of such a contract, transaction, or refusal, shall be valid, irrevocable, and enforceable, save upon such grounds as exist at law or in equity for the revocation of any contract.

9 U.S.C.A. § 1. Notwithstanding this provision, arbitration clauses may be invalidated based on a number of state common law grounds, including procedural unconscionability, substantive unconscionability, and fraud.

While arbitration is not subject to appeal, an arbitrator's decision may be vacated due to the following circumstances:

> (1) where the award was procured by corruption, fraud, or undue means;
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> (2) where there was evident partiality or corruption in the arbitrators, or either of them;
>
> (3) where the arbitrators were guilty of misconduct in refusing to postpone the hearing, upon sufficient cause shown, or in refusing to hear evidence pertinent and material to the controversy; or of any other misbehavior by which the rights of any party have been prejudiced; or
>
> (4) where the arbitrators exceeded their powers, or so imperfectly executed them that a mutual, final, and definite award upon the subject matter submitted was not made.

9 U.S.C.A. § 10. An arbitrator's "manifest disregard of the law" may also serve as an independent basis to invalidate an arbitration award.[2]

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[2] See Stolt-Neilsen, S.A. v. AnimalFeeds Int'l Corp., 130 S. Ct. 1758 (2010).

The American Arbitration Association (AAA) is commonly designated as the required arbitration forum in franchise agreements, in which case the AAA's arbitration procedures will be deemed part of the parties' agreement. As with the NFMP, many arbitrators with the AAA have significant experience in the franchise industry and are therefore better qualified to effectively preside over disputes between franchisors and franchisees.

D. Dispute Resolution Clauses in Franchise Agreements

Many franchise agreements contain basic mediation and/or arbitration clauses. Mediation clauses simply require the parties to mediate controversies arising from the franchise agreement, without resulting in a waiver of either party's right to pursue alternative relief. A sample mediation clause is attached hereto as Appendix A. Arbitration clauses generally include more detail concerning the terms under which the parties will agree to mediate. Topics typically addressed in arbitration clauses include, the number of arbitrators, the arbitrators' required qualifications, the location of the arbitration, permissible discovery, and attorneys' fees and costs, among others. A sample arbitration clause is attached hereto as Appendix B.

Other franchise agreements contain detailed multi-step dispute resolution clauses that describe specifically how and when disputes will be handled. Such clauses require the parties to attempt each form of dispute resolution before proceeding to the next. As an example, an agreement may require the parties to first attempt direct negotiation, then, if that method fails, permit them to proceed to either mediation or arbitration. A sample multi-step dispute resolution clause is attached hereto as Appendix C.

IV. ADR vs. Litigation: Considerations and Strategies

Parties may be prompted to negotiate, mediate, or arbitrate for a number or reasons. As one example, the franchisee may be in default of the franchise agreement. By sending a notice of default or notice of termination, the franchisor may encourage the franchisee to come to the negotiation table. Of course, a demand for arbitration made in accordance with the parties' franchise agreement will also suffice.

As the parties commence ADR, it is important that they preserve their rights to file suit should all ADR fail.[3] Accordingly, once engaged, counsel should analyze what claims may be available to their clients and what limitations periods apply to each respective claim (and then carefully diary the applicable deadlines). As these deadlines approach, and if the parties are still actively negotiating, mediating, or arbitrating, the parties should consider executing a tolling agreement to preserve their respective rights. A tolling agreement temporarily

[3] Of course, there may be a strategic reason why a party would want to prohibit a lawsuit and require ADR as the sole avenue of redress.

extends the time within which the parties may file the subject claims for a given period, notwithstanding the running of a statute of limitations period. A sample tolling agreement is attached hereto as Appendix D.

It is critical that all parties' goals and legal rights are understood at the outside of the ADR session by those participating. Further, if the parties truly intend to resolve their dispute through ADR, it is important that they remain open to creative solutions. As discussed, a major benefit of ADR is the flexibility it provides to all parties involved. To take advantage of this benefit, as well as the many others discussed above, the parties must approach ADR with an open mind.

Finally, it should be noted that, in certain states, agreements reached in mediation are unenforceable unless they are memorialized in writing. Thus, if an agreement is reached through mediation – or even direct negotiation – it is essential that the parties immediately reduce their agreement to writing, and with as much detail as possible.