CURRENT LEGAL ISSUES ARISING FROM HOSPITALITY FRANCHISE AGREEMENTS

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I. SCOPE OF ARTICLE

This article discusses several topics that are common in franchise litigation. This article begins with a discussion of the implied covenant of good faith and fair dealing that may define the rights and obligations of parties to a franchise agreement. The article then discusses the use of covenants not to compete in franchise agreements. The article will then examine the related topic of encroachment by a franchisor into a franchisee's protected territory. Next, the article will discuss forum selection clauses and choice of law provisions that may be included in franchise agreements. This article will also discuss some alternatives to traditional court-based resolution of franchise disputes, with a special emphasis on arbitration agreements. This article will examine the possible liability of a franchisor for the actions of a franchisee or a franchisee's employee. Finally, a few franchise related ethical issues will be discussed.

This article does not provide a complete discussion of any of these issues, but rather seeks to raise issues that typically arise in franchise litigation. The article also seeks to highlight some proactive steps that can be taken in drafting franchise agreements that will reduce the likelihood of litigation.

II. IMPLIED COVENANT OF GOOD FAITH AND FAIR DEALING

A. What is it?

An implied covenant of good faith and fair dealing is essentially a term a court will read into a contract. This covenant requires the parties to the contract to act with good faith towards each other. This covenant ensures that "neither party shall do anything which will have the effect of destroying or injuring the right of the other party to receive the fruits of the contract." *Shree Ganesh, Inc. v. Days Inn Worldwide, Inc.*, 192 F.Supp.2d 774, 784 (N.D. Ohio 2002). In the context of a hotel franchise agreement, courts have held that this implied covenant may be violated by the franchisor's bad faith inspections of a franchise. The franchise argued that the franchisor inspected the hotel in bad faith in an attempt to justify termination of the hotel's franchise. The franchise believed that the franchisor's purpose was to terminate the franchise so it could enter into a new agreement with another franchise. *See Cathay Enterprises v. Ramada Franchise Systems, Inc.*, CCH Business Franchise Guide, ¶ 12,402 (D. Ariz. 2002).

B. When does it apply to a contract?

Whether or not there is an implied covenant of good faith and fair dealing depends on which state's law governs the contract. The courts in many states have imposed the implied covenant on all contracts. For example, every contract in New Jersey contains an implied covenant of good faith and fair dealing. *Shree Ganesh*, 192 F.Supp.2d at 784. Louisiana also recognizes an implied covenant of good faith and fair dealing in every contract. *See Clark v. America's Favorite Chicken Co.*, 110 F.3d 295, 297 (5th Cir. 1997). In other states, a limited implied covenant is created by state law. These covenants are described as limited because they generally create a duty of good faith only in certain parts of franchise agreements. For example, in Tennessee, a franchisor cannot terminate a franchise prior to the expiration of its terms, except for good cause asserted in good faith. *See* Tenn. Code. Ann. § 47-25-103.

Some states have refused to create an implied covenant of good faith and fair dealing in all contractual relationships. *See Subaru of America, Inc. v. David McDavid Nissan, Inc.*, 84 S.W.3d 212, 225 (Tex. 2002) ("A common-law duty of good faith and fair dealing does not exist in all contractual relationships."). More specifically, Texas has specifically rejected the application of any implied good faith and fair dealing duty to all franchise agreements. *Id*. There may be situations, however, where the parties to a franchise agreement are held to a duty of good faith and fair dealing because of a special relationship between the parties. *See Crim Truck & Tractor Co. v. Navistar Int'l Transportation Corp.*, 823 S.W.2d 591, 594 (Tex. 1992) (noting

that parties to an agreement may have a "special relationship" which justifies imposing a duty of good faith and fair dealing on the parties). This "special relationship" has been found to exist between an insurer and the insured based on the disparity in bargaining power between the parties, and the potential for abuse by the insurer. A franchise agreement alone, however, does not establish a "special relationship." *See Crim Truck*, 823 S.W.2d at 595.

Finally, the inclusion of certain language in a contract may be found to create an implied covenant of good faith. Courts have found that when a party to a contract agrees to do something "reasonably," that party has basically agreed to act pursuant to good faith and fair dealing. *Choice Hotels International, Inc. v. Madison Three, Inc.*, 83 F.Supp.2d 602, 608-09 (D. Md. 2000) (equating the idea of reasonableness with the implied covenant of good faith and fair dealing).

C. What effect does the implied covenant have on express contract terms?

This is an area of current dispute. The effect of an implied covenant of good faith is a question of state law, and the states vary greatly in their differences on this issue. Specifically, the states appear to be split on the issue of whether an implied covenant of good faith and fair dealing takes precedence over express contractual terms. The situation is generally as follows: The franchisor performs some conduct that is expressly allowed under the franchise agreement, this conduct, however, has a detrimental impact on a franchisee, but provides a benefit to the franchisor. In such a situation, can the franchisee bring a lawsuit based on the violation of the implied covenant of good faith and fair dealing? In these situations, courts generally employ one of three approaches.

1. Express terms prevail over an implied covenant of good faith

Many courts have indicated that a franchisee is unable to bring a claim based on the violation of the implied covenant if the contract speaks to the issue at hand. In these courts, the implied covenant of good faith and fair dealing will not modify or override express contractual terms. One court has noted that "there can be no breach of an implied covenant of good faith where the party to a contract has done what the provisions of the contract expressly give him the right to do." *Nobel Lodging, Inc. v. Holiday Hospitality Franchising, Inc.*, 548 S.E.2d 481, 484 (Ga. App. 2001). In *Nobel Lodging*, Holiday Inn and Nobel entered into a licensing agreement which required Nobel to make improvements to the physical facilities of the hotel. When Nobel failed to make these improvements, Holiday Inn terminated the license agreement. Nobel filed suit alleging Holiday Inn breached the implied covenant of good faith by terminating the agreement. The court rejected this argument because under the express terms of the licensing agreement Holiday Inn had the right to terminate the agreement due to Nobel's failure to make the required improvements. Other courts have also rejected claims based on an implied covenant of good faith when the contract expressly dealt with the situation at issue. *See Piantes v. Pepperidge Farms, Inc.*, 875 F.Supp. 929, 937-40 (D. Mass. 1995); *Shawmut Bank, N.A. v. Wayman*, 606 N.E.2d 925, 928 (Mass. App. Ct. 1993).

In another case, the plaintiff, who owned several Popeye's Fried Chicken franchises, brought suit against the franchisor, which also controlled the Kentucky Fried Chicken franchise. The franchisor operated several KFC's in close proximity to the plaintiff's Popeye's. The owner alleged that this conduct violated the implied covenant of good faith imposed by Louisiana law. The court disagreed because the contract expressly gave the franchisor the right to operate competing restaurants under different names. The court believed that the franchisor's conduct in doing what it had the express contract right to do could not constitute a violation of the implied covenant of good faith and fair dealing. *See Clark v. America's Favorite Chicken Co.*, 110 F.3d 295 (5th Cir. 1997).

2. Implied covenant applies to areas where contract is silent or unclear

In some states, the implied covenant is treated as a "gap-filling approach" where it applies to issues that the parties did not contemplate at the time the agreement was entered into. Generally, in these situations, any express terms of the contract control, but if the contract is silent as to the issue in dispute, the court will require that the parties act in compliance with the implied covenant of good faith. *See L.A.P.D., Inc. v. General Electric Corp*., 132 F.3d 402, 404 (7th Cir. 1997). The Pennsylvania Supreme Court has stated that an implied covenant of good faith "serves the valuable purpose of defining contractual relations *which have been left unresolved by the parties*." *Witmer v. Exxon Corp.*, 434 A.2d 1222, 1226 (Pa. 1981).

Courts have also indicated that the implied covenant is applicable where a contract is vague or ambiguous as to one of the party's rights. In one case where the franchisor was obligated to furnish "national account leads" to a franchise, the court found this language was vague as to which leads the franchisor could withhold. The court imposed a duty of good faith on the franchisor's exercise of its discretion to withhold a lead or not. *See Interim Health Care of Northern Ill. v. Interim Health Care, Inc.*, 225 F.3d 876 (7th Cir. 2000).

In a case that illustrates the "gap-filling approach," Camp Creek, a franchisee, sued Sheraton, the franchisor, when Sheraton opened a new hotel in close proximity to Camp Creek's hotel. The franchise agreement expressly allowed Sheraton to permit competing franchisees to open hotels near Camp Creek's hotel, but was silent as to whether Sheraton itself could open a hotel near Camp Creek's hotel. The court held that due to the express terms of the contract, Sheraton could properly allow a competing franchise to operate across the street from Camp Creek's hotel, but the implied covenant of good faith would determine whether Sheraton could compete with its own franchises in the same location. The court ruled that it was unclear if Sheraton's conduct in opening a hotel near Camp Creek's hotel would violate the duty, and sent the case back to the trial court. *See Camp Creek Hospitality Inns, Inc. v. Sheraton Franchise Corp.*, 139 F.3d 1396, 1404-05 (11th Cir. 1998). Thus, for this court, the express terms of the contract would control, but an implied covenant of good faith would be imposed where the contract did not expressly deal with the situation at issue.

3. Implied covenant of good faith modifies the express terms

Other courts, however, have indicated that a party can violate the implied covenant of good faith even when they are exercising an express right under the contract. In one such case, the hotel franchisee argued that the franchisor began to give the franchisee poor quality assurance scores just after the franchisor learned that the franchisee wanted to terminate the franchise agreement. The franchisor used these poor scores to terminate the franchise agreement as it was allowed to do by the express terms of the agreement. The court, however, ruled that a "party to a contract may breach the implied covenant of good faith and fair dealing in performing its obligations *even when it exercises an express and unconditional right to terminate.*" *Shree Ganesh, Inc. v. Days Inn Worldwide, Inc.*, 192 F.Supp.2d 774, 784 (N.D. Ohio 2002).

III. COVENANT NOT TO COMPETE

A. What is a covenant not to compete?

A covenant not to compete is often included in franchise agreements. Such covenants generally prohibit the franchisee from competing with the franchisor's business after the termination of the franchise agreement. For example, a franchise agreement could prohibit the franchisee from operating a competing business in the same city as the old franchise for a period of two years after termination of the franchise agreement. The purpose of these covenants is to prevent a franchisee from building its business on the

strength of the franchise name, and then to terminate the franchise agreement and continue operating a similar business at the same location without having to pay franchise fees. A franchise agreement may include both "within term" and "post-term" covenants. A "within term" covenant generally prohibits a franchise from opening a non-franchise business that competes with the franchise during the term of the franchise agreement. A "post-term" covenant prohibits a franchisee from operating a competing business after the franchise ends.

Most covenants not to compete contain three types of restrictions. First, they establish a time limit on when the franchisee cannot compete. Second, they establish a geographic area in which the franchisee cannot compete. Finally, they specify the types of activities that the franchisee cannot perform. As one sample franchise agreement stated:

> The Franchisee and the principals hereinafter named shall not, for a period of two (2) years have any direct or indirect interest in any sandwich restaurant business located or operating within five miles of the Franchised Business if the Franchised Business is located on [sic] a metropolitan area.

See The Quizno's Corp. v. Kampendahl, No. 01C6433, 2002 WL 1012997 (N.D. Ill. May 20, 2002).

If a franchisee violates a covenant not to compete, a franchisor might consider bringing a lawsuit seeking an injunction to compel the franchisee to stop the prohibited activity. To be successful in such a suit, the franchisor must demonstrate four factors: 1) a likelihood of success on the merits; 2) the balance of harm favors the franchisor; 3) the public interest favors the franchisor; and 4) the franchisor will suffer irreparable harm without an injunction. A court will balance these four factors to determine whether or not to issue the injunction requested. The likelihood of success on the merits factor will be fact dependent and usually depends on whether or not the court finds the covenant to be valid or not. For the balance of harms factor, the franchisor must show that granting an injunction will prevent more harm than it will cause. The public interest factor examines if granting the injunction will cause harm to people outside of the litigation. A court may deny an injunction that would shut down a business that many people depend on, even if the business is violating a covenant not to compete. As to the irreparable harm factor, the franchisor must demonstrate they will suffer a harm that cannot be remedied by money damages. In the franchise context, a franchisor typically argues that irreparable harm will result due to damage to the franchise's goodwill, trade secrets, or other proprietary property. Where a clear violation of the Lanham Act exists, irreparable harm is presumed. Thus, an injunction may be appropriate to prohibit an ex-franchisee from using the franchise's customer lists. After the franchisor has lost these customers, they cannot be made whole again by an award of money damages.

B. Are covenants not to compete valid?

In principle, covenants not to compete violate the general policy that every person has the right to earn a living how and where they can. These covenants act as a restraint of trade by limiting the right of a person to operate a business in specified areas for specified periods of time. For these reasons, these covenants are generally not favored, and tend to be strictly interpreted by the courts.

Covenants not to compete are expressly invalid in some states. Under California law, "every contract by which anyone is restrained from engaging in a lawful profession, trade, or business of any kind is to that extent void." *See* Cal. Bus. & Prof. Code § 16600. This statute has been specifically applied in the context of a covenant not to compete included in a franchise agreement. *See Scott v. Snelling and Snelling*, 732 F.Supp. 1034, 1040-42 (N.D. Cal. 1990).

In most states, however, there is not a blanket prohibition on such covenants. In such cases, covenants not to compete still tend to be strictly analyzed by courts and narrowly interpreted. Where they are not expressly prohibited, most states have created a test to determine if a covenant is valid. In Texas, a covenant not to compete is enforceable to the extent that it is: 1) ancillary to an otherwise enforceable agreement; and 2) contains reasonable limitations as to time, area and scope of activity. *See* Tex. Bus. & Com. Code Ann. §§ 15.50, 15.51. This test is fairly standard, as most states require covenants to be reasonable as to time, area and scope of activity. In determining if a covenant is reasonable, the courts "focus on the need to protect a legitimate interest of the [franchisor] and the hardship of such protection on the [franchisee] and the public." *DeSantis v. Wackenhut Corp.*, 793 S.W.2d 670, 683 (Tex. 1990). Courts have identified several legitimate interests of a franchisor, including: business goodwill, trade secrets, customer lists, pricing policies, bidding strategies, and other proprietary information. These interests are balanced against the general principle of free markets, and the rights of the franchisee to earn a living.

C. What has been found reasonable?

The determination of whether a covenant is reasonable or not is obviously very fact dependent. It will depend on the nature of the business, the specific trade secrets at issue, and the severity of the time, area and activity limitations. In one Texas case, the franchise agreement included two covenants not to compete. The "post-term" covenant prohibited the franchisee from opening a competing fruit and nut store, for two years after the termination of the franchise agreement, in the same mall in which he operated the franchise. The "within term" covenant prohibited the franchisee from opening any fruit and nut store in the same metropolitan area while the franchise agreement was in effect. The franchisee later opened another fruit and nut store in a nearby city. After a few years, the franchisor terminated the franchise agreement, but the franchisee continued to operate the store under the franchise name. The franchisee filed a lawsuit arguing that the franchisee violated both covenants. The franchisee responded by arguing that the covenants were invalid. The court believed the first covenant was reasonable as it was lasted two years, and it covered only a limited area, the mall. As to the second covenant, the court believed it was unreasonable. The court appeared to believe that the term "metropolitan area" was not clear and that it was still too broad. As it applied to more territory than was necessary to protect the franchisor's interests, the covenant was invalid. *See Butts Retail, Inc. v. Diversifoods, Inc.*, 840 S.W.2d 770 (Tex. App.—Beaumont 1992, writ denied). Another court, applying Texas law, has found much more restrictive covenants to be enforceable. The court found that a "post-term" covenant that imposed a one-year, twenty-mile radius restriction on the operation of a competing business was reasonable. *See Meineke Discount Muffler v. Jaynes*, 999 F.2d 120 (5th Cir. 1993).

In another case, the court upheld a "post-term" covenant that prohibited the former franchise owners from operating, for a period of one year, any sporting goods store within a six-mile radius of the old franchise, or within a six-mile radius of any other of franchise. *See Grow Biz International, Inc. v. MNO Inc.*, No. CIV. 01-1805, 2002 WL 113849 (D. Minn. Jan. 25, 2002). In a case involving a Quizno's franchise, a court upheld a "post-term" restriction with a five-mile radius that lasted two years. The court noted that other courts had found covenants that applied to much larger areas reasonable. The court specifically referred to a restriction in one case that applied to the entire "Denver metropolitan market." *See Kampendahl*, 2002 WL 1012997, at *4.

D. What is the effect of an invalid covenant not to compete?

If a court finds a covenant not to compete to be invalid as exceeding what is reasonable, the court will generally strike only the portion of the covenant that is unreasonable. The courts in most states will "blue pencil the covenant" to make it reasonable. For example, in New York, "if a court finds a limitation to be

unreasonable, it can 'blue pencil' the covenant to restrict the term to a reasonable geographic limitation." *See Unisource Worldwide, Inc. v. Valenti*, 196 F.Supp.2d 269, 277 (E.D.N.Y. 2002).

In some states, however, any unreasonable term in a covenant not to compete will void the entire covenant. "Under Georgia law, a single unreasonable provision in restrictive covenant will void the entire contract, and courts will not 'blue line' covenant to salvage any non-offending parts." *See Keener v. Convergys Corp.*, 205 F.Supp.2d 1374, 1380 (S.D. Ga. 2002). In such states, the party who drafts the covenant not to compete should err on the side of caution and make any restrictions as minimal as possible to protect its interests. Other courts have indicated that they will not "blue pencil" a covenant when the drafter had deliberately included unreasonable and oppressive terms in the covenant. *See Laidlaw, Inc. v. Student Transp. of America, Inc.*, 20 F.Supp.2d 727, 765 (D.N.J. 1998). Again, such decisions indicate any covenant not to compete be drafted as narrowly as possible.

IV. ENCROACHMENT

The term "encroachment" refers to the situation where a franchisor directly competes with its franchisees or allows another franchise to operate near an existing franchise. The primary issue raised in such situations is whether or not the franchisor is permitted to engage in such conduct. To answer this question, a court will look at the terms of the franchise agreement to determine what the parties agreed to. If the agreement expressly provides or denies a franchisor the right to encroach on existing franchises, then a court will generally enforce the terms of the contract. As one court stated, "The better reasoned authority defines the parties' commercially reasonable expectations in light of the express language in the franchise agreement with respect to exclusive rights and protected market areas." *Primrose Food Services, Inc. v. Romacorp, Inc.*, CCH Business Franchise Guide, ¶ 11,990 (Cal. Ct. App. 2000). However, problems arise when a contract does not expressly state the encroachment rights or limits of a franchisor.

A. Explicit encroachment provisions

An "encroachment" or "protected territory" provision refers to a term in a contract that specifically defines either the rights of a franchisor to encroach on its franchises or a term that specifies an area where the franchisor has agreed not to interfere with a franchise. Encroachment provisions are similar in purpose to covenants not to compete, but they are intended to protect the franchisees. These provisions generally prohibit the franchisor from itself competing with one of its franchisees in a given area, or they may prohibit the franchisor from allowing other franchises to open near existing franchises. These encroachment provisions create an area of protected territory for a franchise where it knows they will not have to compete with other franchises. For example, Pepsi-Cola grants to each of its bottlers a defined, exclusive geographic territory. *See Pepsi-Cola Bottling Co. of Pittsburg, Inc. v. Pepsico, Inc.*, 175 F.Supp.2d 1288, 1291 (D. Kan. 2001). This territory may be a city, county, group of counties or even an entire state. More commonly, however, a franchise agreement defines the protected territory as a circle with a specified radius. The size of the circle often varies depending on the demographics surrounding a location. For example, a franchise agreement for a store in a dense, urban area may only create a protected territory with a one-mile radius, while a more rural location may have a protected territory with a radius of three, five or more miles. On the other hand, some franchise agreements may specifically state that a franchisee does not have any exclusive or protected territory.

B. What if a franchise agreement is silent on the issue of encroachment?

If a franchise agreement does not define a protected territory or otherwise discuss the issue of encroachment, courts may still find ways to provide some protection to a franchisee. In one case, due to a change in the location of the proposed franchise, the franchise agreement did not specify any protected territory. The plaintiff argued the franchisor had indicated that a protected territory with a radius of one mile would apply to the franchise. The franchisor later acquired a competitor, including two stores within a quarter mile of the plaintiff's franchise. The plaintiff alleging these stores encroached on the protected territory that it should have had. The franchisee argued that the franchise agreement did not define any protected territory, so there was no encroachment. The trial court compromised between these two positions. The court imposed a half-mile radius area of protected territory for the plaintiff's store. The court justified this result by stating "there is a reasonably certain basis for giving an appropriate remedy." The evidence indicated that protected territory should have been included, but was mistakenly omitted. The court believed that such an error should not divest the franchisee of the protected territory they relied on in signing the franchise agreement. *See Oganesov v. GNC Franchising, Inc.*, CCH Business Franchise Guide, ¶ 11,808 (Pa. Com. Pl. 2000).

Even if a franchise agreement does not include an encroachment provision, a franchisee may have some protection based on the implied covenant of good faith and fair dealing. Courts have held the encroachment of franchisor owned stores to be a breach of the implied covenant. *See Photovest Corp. v. Fotomat Corp.*, 606 F.2d 704 (7th Cir. 1979). As discussed above, if the franchise agreement is silent as to whether or not the franchisor can allow nearby competing franchises to operate, courts may evaluate such conduct based on the implied covenant of good faith and fair dealing. *See also Foodmaker Inc. v. Queshi*, CCH Business Franchise Guide, ¶ 11,780 (Ca. Super. Ct. 1999) ("[T]he express denial of territorial interest to the franchisee herein does not necessarily imply a right to Foodmaker to open franchises at will regardless of their effect on the operations of franchisees. Though the franchisees herein are not entitled to exclusive territory, they are entitled to expect that Foodmaker will not act to impair or destroy their franchisee interest."); *In re Vylene Enterprises*, 90 F.3d 1472, 1477 (9th Cir. 1996) (finding the construction of a competing restaurant within a mile and a half of a franchise was a breach of the covenant of good faith and fair dealing despite the fact that the franchise "did not have any rights to exclusive territory under the terms of the franchise agreement.").

It is important to note, however, that the majority of cases find no violation of the implied covenant of good faith when a franchise agreement expressly provides that the franchisor is free to open franchises as they see fit or when the franchise agreement does not provide any exclusive territory. *See Burger King Corp. v. Weaver*, 169 F.3d 1310 (11th Cir. 1999) (no violation of implied covenant of fair dealing when franchisor opened new franchise near plaintiff because the franchise agreement did not grant the plaintiff any exclusive territory); *Hartford Donuts Inc. v. Dunkin' Donuts Inc.*, CCH Business Franchise Guide, ¶ 12,100 (D. Md. 2001).

C. Non-traditional forms of encroachment

One topic of particular importance in the area of encroachment is the scope of protection in light of new avenues of product distribution. The expansion of Internet-based commerce raises many significant issues in defining and protecting a franchise's exclusive territory. For example, if a franchise grants a franchise an exclusive territory covering a radius of five miles from that franchise, can the franchisor sell its products over the Internet to people who live in franchise's exclusive territory? Newer franchise agreements may have been written with such a situation in mind. One such agreement allows the franchisor to sell and distribute any goods, directly or indirectly, to businesses or individuals in a franchise's protected territory by "direct mail, mail order, catalog sales, or any other similar method." *Lee v. General Nutrition Co., Inc.*, No.

CV 00-1355LGB, 2001 WL 34032651 (C.D. Cal. Nov. 26, 2001). Such language ensures that a franchisee would not violate a franchise's protected territory through Internet-based sales to people in that territory.

A different situation emerges when the franchise agreement does not include such language. In at least one case, a franchisor's sale of products over the Internet was found to violate the franchisees exclusive territory rights. *See Emporium Drug Mart Inc. of Shreveport v. Drug Emporium, Inc.*, American Arbitration Association, Case No. 711140012600 (Sept. 2, 2000). In this case, the franchisor agreed that it would not operate a "drug store" within a franchise's protected territory. The court found that the franchisor's "online drug store" violated this agreement and issued an injunction to shut down the Internet site. As this case was resolved in arbitration, it is not binding on any courts of law. Courts can, and likely will, rule on this issue with a variety of results. One commentator noted three morals of this decision. First, a franchisor must carefully examine its franchise agreements as most decisions will likely turn on the specific language used in the agreements. Franchisors need to conduct themselves within the bounds of the language they have agreed to. Second, franchisors need to plan for the future and ensure that new franchise agreements will deal with this issue in the manner that the franchisor desires. Third, franchisors should examine the business impact of using the Internet to compete with their own franchises. *See* Rupert Barkoff, *Expanding a Franchise System Through the Internet: Encroachment or Opportunity?*, Leader's Franchise Bus. & Law Alert (November 2000).

V. FORUM SELECTION AND CHOICE OF LAW PROVISIONS

A. Forum selection clauses

1. What is a forum selection clause?

Forum selection clauses are contract terms that specify in what courts any disputes based on the contract must be brought. Such clauses create some certainty and predictability in potential litigation. Often these terms are used to ensure a dispute is heard in a court that is convenient to the party who drafted the contract. In franchise cases, such a clause usually favors the franchisor by requiring any litigation be brought in the forum that the franchisor is most comfortable with.

2. Is a forum selection clause valid?

The Supreme Court has held that a forum selection clause is presumptively valid. Such clauses will be stricken from a contract only if the party opposing them can demonstrate fraud, duress or some other general contract defense. However, courts generally require the party opposing the clause to demonstrate that forum selection clause itself was fraudulently induced. *See Scherk v. Alberto-Culver Co.*, 417 U.S. 506, 519 n.19 (1974). Under this test, the opposing party must "clearly show that enforcement would be unreasonable or unjust, or that the clause is invalid for such reasons as fraud or overreaching." *The Bremen v. Zapata Off-Shore Co.*, 407 U.S. 1, 15 (1972).

Some states have specific rules regarding forum selection clauses in franchise agreements. For example, in California a forum selection clause is void in any case relating to a franchise agreement involving a franchise that operates within California. *See* Cal. Bus. & Prof. Code § 20040.5. Courts have often relied on this statute to hold a forum selection clause invalid. In one case, the franchisor sought to dismiss a case that a franchisee filed in California despite a forum selection clause which required all lawsuits to be brought in Pennsylvania. The court noted that a forum selection clause is not enforceable if it violates a strong public policy of the state in which the lawsuit was brought. The court noted that the statute announced the public policy of California regarding forum selection clauses. Based on this statement of

public policy, the court declined to enforce the forum selection clause and refused to dismiss the case. *See Jones v. GNC Franchising, Inc.*, 211 F.3d 495, 497-98 (9th Cir. 2000).

3. What is the effect of a forum selection clause?

If a party initiates a lawsuit in a forum that is not specified in the forum selection clause, the opposing party generally has two remedies. It can either seek to have the suit transferred to the proper forum, or it can seek to have the lawsuit dismissed. *See Jones*, 211 F.3d at 496-97. If the lawsuit is dismissed, the party can generally refile the lawsuit in the proper forum. In one case, the court transferred a case from the Federal District Court for the Eastern District of Texas to the Federal District Court for the Northern District of Texas based in large part on a forum selection clause. The court noted that "the presence of a forum selection clause will be a significant factor" in its decision to transfer or not. In making this decision, the court also considered whether or not the clause was invalid due to fraud, and compared the reasonableness and convenience of the two forums. *See ABC Rental Systems, Inc. v. Colortyme, Inc.*, 893 F.Supp. 636 (E.D. Tex. 1995). Often the two competing forums will not be so close. Courts in Texas have transferred cases to Virginia based on the forum selection clauses and the other factors discussed above. *See Brock v. Entre Computer Centers, Inc.*, 740 F.Supp. 428 (E.D. Tex. 1990) (deciding to transfer case rather than dismiss).

B. Choice of law provisions

1. What is a choice of law provision?

Choice of law provisions take forum selection clauses one step further. They provide even greater certainty and predictability because they dictate what body of law the court will apply. These provisions may indicate a law different than that of the forum selected by the forum selection clause. Thus, an agreement may require any lawsuit be filed federal court in New York, but also require that the court apply California law to the dispute. Such a combination of provisions can ensure that the dispute is heard in both the most convenient forum, and under the most favorable law to the party who drafts the agreement.

2. Is a choice of law provision valid?

As with forum selection clauses, choice of law provisions are generally enforced absent fraud, duress, statute, or conflicting public policy. Some states have additional tests for choice of law provisions. For example, in New York, a court may decline to enforce a choice of law provision if either 1) the law of the state selected does not have a reasonable relationship to the economic activity or 2) the law of the state selected violates a fundamental public policy of the forum court. *See LaGuardia Associates v. Holiday Hospitality Franchising, Inc.*, 92 F.Supp.2d 119, 127 (E.D.N.Y. 2000).

Many states have adopted Franchise Acts that specifically deal with choice of law provisions. These Franchise Acts often include what are known as non-waiver laws which state that a party to a franchise agreement cannot waive application of that state's law. For example, under the Minnesota Franchise Act, any provision "purporting to bind any person acquiring a franchise to waive compliance" with the Franchise Act is void. *See* Minn. Stat. § 80C.21. Such a law ensures that people who open franchises in the state will not have their dispute governed by the laws of a distant and unrelated state.

Disputes arise when a choice of law provision and a non-waiver statute like Minnesota's are found to conflict. In one case, the franchise agreement specified that the agreement would be construed in accordance with the laws of Minnesota. The franchisee argued that, as an Illinois based franchise, the non-waiver provisions of the Illinois Franchise Disclosure Act would apply, and Illinois law would govern the dispute. The court held that the Illinois Act did void the choice of law agreement in the contract, and the court applied

Illinois law. *See Healy v. Carlson Travel Network Associates, Inc.*, No. CIV. 01-1103ADM/SRN, 2002 WL 31356218 (D. Minn. Oct. 16, 2002).

VI. ALTERNATIVES TO TRIAL

Many franchise agreements include provisions intended to avoid dispute resolution in the court system. These provisions can take a variety of forms. Most common are contractual terms that require the parties to either submit to non-binding mediation, non-binding arbitration or binding arbitration of any dispute based on the franchise agreement. Such terms will almost universally be enforced absent fraud or other improper conduct by one side. Generally, courts indicate that such provisions are simply a matter of contract law, they are the methods that the parties have agreed to resolve their disputes, and the courts will enforce the terms.

A. Mediation

Some agreements include clauses that require the parties to submit to non-binding mediation before they can file a lawsuit. Such clauses have several benefits. They can potentially lead to a resolution of the dispute in a peaceful manner before litigation in court has soured the relationship between the parties. Successful mediation is substantially quicker and cheaper than litigation. The mediation is generally non-binding which makes the attempt to mediate a win-win situation. If mediation is successful, the parties have resolved their dispute in a peaceful and quick manner, and if mediation is unsuccessful, the parties still have the right to bring their dispute to the court system.

B. Arbitration

Arbitration is similar in form to court adjudication. The parties will present testimony, evidence and arguments to a neutral third party that has the power to render a binding decision. Arbitration does vary from litigation in many important respects. Often, the rules of evidence and pre-trial discovery are not followed as strictly in arbitration, and the arbitrator generally only provides a final award. Most arbitrators do not provide reasons for their decision. Arbitration has some benefits over litigation, which may include the superior expertise of the decision-maker, privacy of the proceedings, lower cost, and faster resolution of disputes. An award issued by an arbitrator is not self-enforcing. The party who receives an arbitration award must go to court to have the award confirmed for the award to be enforceable. Under the Federal Arbitration Act ("FAA"), a court will confirm an award unless there is a basis to vacate the award. Under the FAA, a court may vacate an arbitration award only if the award was procured by fraud, corruption or other undue means, if there is evidence of corruption or impartiality among the arbitrators, or if the arbitrators were guilty of misconduct or they exceeded their power. Therefore, arbitration awards are not as reviewable as decisions from trial courts and arbitration awards that may be contrary to established law stand.

1. Federal Arbitration Act

Federal law will govern most arbitration clauses in franchise agreements. The Federal Arbitration Act ("FAA") applies to agreements to arbitrate in contracts that involve interstate commerce. The FAA creates a "strong policy in favor of rigorously enforcing arbitration agreements." *Doctors Associates, Inc. v. Hamilton*, 150 F.3d 157, 162 (2d Cir. 1998). The Supreme Court has noted that the reason Congress passed the FAA "was to enforce private agreements into which parties had entered." *Perry v. Thomas*, 482 U.S. 483, 490 (1987). In line with this clear purpose, the FAA is broadly written in favor of enforcing arbitration agreements. For example, the FAA states that arbitration agreements "shall be valid, irrevocable, and enforceable, save upon such grounds as exist at law or in equity of any contract." 9 U.S.C. § 2. This

provision ensures that arbitration agreements are enforceable unless any standard contract defense such as fraud, unconscionability, or duress exists. The Supreme Court has also noted that the person opposing arbitration must demonstrate that the arbitration clause itself was induced by fraud or duress to be invalid. If a party alleges the entire contract is tainted by fraud, the courts will generally just require the party to raise this claim in arbitration. *See Prima Paint Corp. v. Flood & Conklin Mfg. Co.*, 388 U.S. 395, 403-04 (1967) (holding the FAA "does not permit the federal court to consider the claims of fraud in the inducement of the contract generally"). Thus, once a court finds that a valid agreement to arbitrate exists, any challenge to other distinct parts of the contract are to be resolved in arbitration.

The FAA has also been found to preempt all state laws that may burden the enforcement of arbitration agreements. *Southland Corp. v. Keating*, 465 U.S. 1 (1984). This decision is very significant in the franchise context because it allows contractual arbitration agreements to defeat many state franchise laws. As discussed above, many courts have held that state franchise laws will defeat conflicting forum selection clauses. However, under the *Southland* decision, arbitration agreements will preempt state franchise laws. In *Southland*, the Supreme Court held that the FAA "withdrew the power of the states to require a judicial forum for the resolution of claims which the contracting parties agreed to resolve by arbitration." *Id*. at 10.

These arbitration clauses also generally specify where the arbitration will take place. The courts will also enforce these agreements. Under the FAA, a court must order the parties to arbitrate in accordance with the terms of their agreement, and these terms include the location of arbitration. Additionally, along the same lines, courts have relied on arbitration agreements to force the parties to submit to the choice of law provisions in the contract.

2. Procedures related to arbitration

The courts have developed several procedures to deal with disputes over arbitration agreements. Generally, the situation is that one party to the contract has filed a lawsuit in violation of the terms of the arbitration agreement. In such cases, the opposing party can usually request two things from the court. The party seeking arbitration can seek to compel arbitration or they can seek to have the court stay the litigation pending arbitration. When faced with this situation, the court must first decide whether the dispute in question is subject to the arbitration agreement. With many broadly written arbitration clauses, this is not much of an issue. But some more narrowly written arbitration agreements may not cover all possible disputes that may arise between the parties. In close cases, courts have stated that "any doubts concerning the scope of arbitrable issues should be resolved in favor of arbitration." *Moses H. Cone Mem'l Hosp. v. Mercury Constru. Corp.*, 460 U.S. 1, 24-25 (1983). If the court finds that the dispute in question is covered by the language of the arbitration agreement, the court may not rule on the merits of the dispute, but rather the court must either compel arbitration or stay the lawsuit pending arbitration of the dispute.

3. Sample cases involving arbitration agreements

Several cases demonstrate the harsh result that occurs from enforcement of the FAA by the courts. In one recent case involving a Subway franchise, the franchise agreement included a broadly worded arbitration clause. This clause required "any dispute or claim arising out of or relating to" the agreement to be submitted directly to arbitration in accordance with the rules of the American Arbitration Association. The clause also specified that the arbitration hearing would be held in Bridgeport, Connecticut. The franchise agreement also specified that the laws of the state of Florida would govern the franchise agreement. DAI, the Subway franchisor, filed a demand for arbitration over a dispute with Hamilton, a franchisee. Hamilton responded by filing a lawsuit in New Jersey state court alleging fraudulent inducement. In response, DAI went to federal court requesting that Hamilton be compelled to arbitrate the disputes and sought an

injunction to stop the state court proceedings. In federal court, Hamilton challenged that validity of the arbitration clause. Hamilton argued that New Jersey law should apply and that the arbitration clause was invalid under New Jersey law. The court disagreed saying that the FAA preempted New Jersey law. The court also rejected Hamilton's argument that the arbitration clause was unconscionable due to the high cost of traveling to Connecticut. The court noted that the clause was not unconscionable because the contract was clear as to this issue, and Hamilton agreed to arbitrate any dispute in Connecticut. Having made this agreement, Hamilton was bound by it. *See Doctor's Associates, Inc. v. Hamilton*, 150 F.3d 157 (2nd Cir. 1998); *see also KKW Enterprises, Inc. v. Gloria Jean's Gourmet Coffees Franchising Corp.*, 184 F.3d 42 (1st Cir. 1999) (ordering enforcement of arbitration agreement regarding Massachusetts and Vermont based franchises requiring arbitration in Chicago).

VII. VICARIOUS LIABILITY OF FRANCHISOR FOR ACTS OF FRANCHISEES

A. What is vicarious liability?

Another major issue of concern for franchisors is the amount of liability they may have based on their franchisee's harmful conduct. Holding one entity responsible for the conduct of another entity or person is known as "vicarious liability." The question is when will a franchisor be vicariously liable for the actions of a franchisee. While courts have articulated the answer in many different ways, the most significant factor is the level of control the franchisor has over the franchisee' conduct. If a franchisor has the authority to dictate the operations of franchisee in a specific area, the franchisee's misconduct in that area will likely be attributed to the franchisor. "In deciding whether a franchisor may be held vicariously liable for acts of its franchisees, courts determine whether the franchisor controls the day-to-day operations of the franchise, and more specifically whether the franchisor exercises a considerable degree of control over the instrumentality at issue in a given case." *Hong v. Dunkin' Donuts, Inc.*, 105 F.Supp.2d 83, 87 (E.D.N.Y. 2000). Courts have added additional complexity to this issue by stating that "actual control of the manner of work is not essential; rather, it is the right to control which is determinative." *Drexel v. Union Prescription Centers, Inc.*, 582 F.2d 781, 785 (3d Cir. 1978). Therefore, if a franchise agreement gives a franchisor substantial authority to dictate a franchise's operations, but the franchisor does not use this authority, a court may still find the franchisor is vicariously liable because they had the *right* to control, even if they did not exercise their right.

In deciding whether to impose vicarious liability on a franchisor for the actions of a franchisee, Texas courts may based the decision on whether the franchisee is found to be an agent of the franchisor. Under Texas law, "the party asserting agency must prove that the principal has both the right to assign the agent's task and the right to control the means and details by which the agent will accomplish the task." *O'Byrant v. Century 21 South Central States, Inc.*, 899 S.W.2d 270, 271 (Tex. App.—Houston [14th Dist.] 1995, no writ). In making this determination in a franchise context, the courts may analyze several factors. First, the terms of the franchise agreement will be relevant. For example, in one case, the franchise agreement stated that the franchisee was an independent contractor, and that the "conduct of Franchisee's business shall be determined by its own judgment and discretion." *Id.* at 272. Additionally, the court will examine how much control the franchisor has over the operations of the franchisee.

In *O'Bryant*, the plaintiff alleged that the franchisee realtor failed to provide a safe leased premises and misrepresented the safety of the neighborhood. The plaintiff also argued that the franchisor was vicariously liable for these actions. The court concluded that there was no vicarious liability because the franchisor had no right to control the manner in which the franchise listed and leased properties. The court also noted that the franchisor did not regulate the details of the work performed by the franchisee or its employees, the working conditions of the franchisee's employees, or the franchisee's contacts with customers. *Id.* at 271-72. The court concluded that these factors established that the franchisor did not have

a "right of control over the day-to-day operation" of the franchisee. The court also indicated for vicarious liability to be appropriate, the franchisor's right to control must apply to the specific matter complained of. Because the dispute regarded a matter the franchisor did not control, the franchisor would not be held vicariously liable. *Id*.

B. Sample cases on vicarious liability

In an illustrative case, the court found that Denny's, Inc. was responsible for the acts of sexual harassment committed by employees of one of its franchisees. The court based this decision on the fact that these employees were agents of Denny's Inc. The court noted that the "principal's consent and right to control are the essential elements of an agency relationship." *Miller v. D.F. Zee's Inc.*, 31 F.Supp.2d 792, 806 (D. Ore. 1998). The court provided many examples of how Denny's Inc. had the right of control over the franchisees. The franchise agreement required franchisees to comply with many comprehensive manuals, Denny's, Inc. had the right to inspect the franchises to ensure compliance, and Denny's, Inc. trained franchise employees in diversity and non-discrimination matters. Denny's, Inc. argued that the franchise agreement specifically stated that a franchise's employees are not considered employees of Denny's, Inc. The court believed that this disclaimer was not controlling; which indicates that substance will prevail over form regarding the relationship between a franchise and the franchisor.

One recurring fact pattern in vicarious liability cases is when a person is attacked on a franchise's premises and ultimately sues the franchisor. In these cases, the main focus is on how much control the franchisor had over security measures at the franchise locations. There have been many cases where the courts held that a franchisor did not have a sufficient level of control over security matters to be held vicariously liable. *See Lewis v. McDonald's Corp.*, 664 N.Y.S.2d 477, 479 (New York App. Div. 1997) (McDonald's Corp. not liable in case brought by patrons who were assaulted in franchise parking lot). Several courts have indicated that a franchisor's right to enforce standards, or to terminate a franchise for failure to comply with the standards, does not amount to sufficient control for vicarious liability. Additionally, a right to enter the franchise and to inspect generally does not constitute sufficient control. These cases have led at least one court to conclude that "a showing of actual control over security measures" is necessary to hold a franchisor vicariously liable. *Hong*, 105 F.Supp. at 90. In *Hong*, a franchise employee was assaulted and raped while working. She sued the franchisor for failure to provide adequate safety. The court held that the franchisor was not vicariously liable. The franchisor did not require any safety systems, and did not require the safety systems that failed to prevent the attack. The court noted that the franchisee hired an independent safety consultant who suggested installation of the Plexiglas partition, alarm system and video cameras. These safety features were not functioning when the attack occurred, but they were not the responsibility of the franchisor. Other cases, however, have found that a franchisor's right to inspect plus a franchisee's duty to comply with operational and training manuals to be sufficient to let a jury decide the issue of vicarious liability. *Butler v. McDonald's Corp.*, 110 F.Supp.2d 62, 67 (D. R.I. 2000).

C. Issues raised by vicarious liability

These cases present difficulties for both franchisors and franchisees. They are generally very fact intensive, and therefore, are often cases that must go to trial to be resolved. A franchisor is placed in a constrained position. If it does not require the franchises to comply with detailed policies and procedures, the franchises may depart from the levels of appearance and quality that the franchisor expects. But if the franchisor imposes many specific requirements on the franchises, courts may later find the franchisor exercised enough control over a franchise to be held vicariously liable for the franchise's conduct. Moreover, many courts have indicated that statements in the franchise agreement that disclaim an agency relationship will generally be ignored. Therefore, franchisors must find the narrow ground between too

much and too little control over specifics of franchise operations to ensure that their interests are fully protected.

Additionally, franchisees are placed in a difficult position. If a franchisor does not dictate specific policies on an issue, the franchisee may believe it is free to deal with the issue as it sees fit. But without any guidance from the franchisor, the franchisee may not know what is expected or required of them. A franchisee may fail to enact adequate safety precautions simply because the franchise agreement does not require him to do so. Likewise, another franchisee may error on the side of caution and enact more safety precautions than are necessary.

VIII. ETHICAL CONSIDERATIONS

A. Drafting franchise agreements

As the *Oganesov v. GNC Franchising* case discussed above illustrates, important terms are often inadvertently omitted from the final franchise agreement. One common ethical dilemma concerns the duty of one party's counsel to inform the opposing counsel of any omissions that they discover. For example, Franchisor and Franchisee, with counsel, have negotiated a franchise agreement. The Franchisee did not want to be bound by a "post term" covenant not to compete. The Franchisor insisted on the covenant and the Franchisee ultimately agreed to the covenant. The Franchisor's attorney drafts the agreement and has it signed, but fails to notice that the covenant was not included. The Franchisor sends the agreement to the Franchisee for his signature. The Franchisee's attorney discovers the omission. Does the Franchisee's attorney have a duty to disclose the omission to either his client, the Franchisee, or the adverse party? In a non-binding opinion, the ABA indicated that the attorney need not consult his client regarding the omission, but should contact the Franchisor's counsel regarding the omission. The opinion notes that the Franchisee "does not have the right to take unfair advantage of the error," and that the omission constitutes a "material fact" that must be disclosed to the Franchisor's counsel. *See* ABA Informal Opinion 86-1518 "Notice to Opposing Counsel of Inadvertent Omission of Contract Provision," February 9, 1986.

B. Dual representation and the duty of loyalty

The nature of the relationship between a franchisor and franchisee is often not clear. At most times, the interests of the two parties are similar. Both parties want the franchises to be successful, as this improves both parties' bottom line. But as the many cases discussed above make clear, this mutually beneficial relationship does not always remain. In such cases, the interests of the two parties often become quite adverse. There are many disputes where a conflict of interest between a franchisee and franchisor is obvious. Disputes over encroachment and covenants not to compete clearly place a franchisor and franchisee in adverse positions. There are other disputes, however, where the conflict of interest is less obvious. The potential for these types of disputes raises important ethical issues for attorneys who work with franchises.

A potential situation that raises ethical concerns involves the representation of both the franchisor and a franchisee. One example involves an attorney who worked with the franchisor and who drafted the franchise agreement. During the negotiations, the attorney is introduced to the franchisee. The franchise agreement is signed and the franchise opens for business. A few years later, the franchisee begins to have problems with some of its employees. The franchisee approaches the franchisor's attorney for legal help. Should the franchisor's attorney agree to the representation? In such a case, the attorney should decline representation because such representation could violate the Model Rules of Professional Conduct by affecting the attorney's duty of loyalty to the franchisor. At first glance, it does not appear that representing the franchisee on employment law matters would affect the attorney's duty to the franchisor, but potential conflicts of interest loom.

For example, if the franchisee's dispute with the employee involves a claim of sexual harassment, the franchisee and franchisor could become adverse parties due to the possibility of vicarious liability. In an attempt to shift liability, a franchisee may argue that the franchisor is vicariously liable to the employee due to the amount of control the franchisor had over employment matters and policies. The success of such a claim would depend on the language of the franchise agreement, which the attorney had drafted. Therefore, representing the franchisee could violate the duty of loyalty owed to the franchisor due to the prior representation in drafting the franchise agreement. Model Rule 1.9 states:

> A lawyer who has formerly represented a client in a matter shall not thereafter represent another person in the same or a substantially related matter in which that person's interests are materially adverse to the interests of the former client unless the former client gives informed consent, confirmed in writing.

In the example, Model Rule 1.9 is clearly implicated. The representation of the franchisee in the sexual harassment claim will likely raise issues related to the franchise agreement, which is the exact matter in which the attorney formerly represented the franchisor. This is but one example of a situation where the franchisor and franchisee do not initially appear to be adverse, but may become adverse depending on the nature of the claim or the direction the litigation takes. As it is often unclear if an adverse relationship will appear later in the litigation, a franchisor's attorney should be cautious of representing a franchisee.