

Arbitration Should Not Be That Bad—From the Franchisee's Perspective

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Forty years ago, the desirability of arbitration clauses in franchise agreements was questionable. Few franchisors were bold enough to incorporate this new (at least to franchising) alternative dispute resolution into their agreements. And in those franchise agreements that did contain arbitration clauses, the provisions were very short. The American Arbitration Association (AAA) suggested something like the following:

Any controversy or claim arising out of or relating to this contract, or the breach thereof, shall be settled by arbitration administered by the American Arbitration Association in accordance with its Commercial Rules of Arbitration, and judgment upon the award rendered by the arbitrator may be entered in any court having jurisdiction thereof.

Franchise Agreements Today

Times have changed. Over the years, franchisors realized that litigation had serious flaws. It had become expensive. It often took years to resolve a dispute. And ultimately, trial court decisions could be appealed, thereby extending even further the time to conclusion of the case. As a result, more and more franchisors looked to arbitration as an alternative means to resolve franchise disputes.

Today, it seems that more than half of the franchise agreements currently used to sell franchises contain arbitration clauses, and most of the clauses are designed to give franchisors a finger on the scale to tip the playing field in their favor. Arbitration clauses, if carried to extremes, can become a mini-set of rules of civil procedure.¹ Most, however, do not go so far, but they do move the balance toward the franchisor by specifying favorable choice of law provisions, limitation on damages, and various other carve outs such as claims involving intellectual matters, especially trademark matters. The principal rationale for a trademark carve-out is that trademarks are often the principal assets of franchise systems, and these are disputes where the franchisor wants to have assurance of appeal rights. Appeal rights in franchise arbitration clauses would be unusual.

Whether for better or worse, arbitration clauses can lead to multiple actions in the same dispute over the same subject matter. For example, the franchisee brings an action in court in contravention of the terms of the franchise agreement, and the franchisor either moves to have the arbitration proceeding dismissed or stayed pending the outcome of the arbitration proceeding. If the franchisor loses on its motion to dismiss or stay, the franchisor then appeals that decision, and often the arbitration is stayed pending the resolution of the appeal. If the franchisee loses on any of these motions filed by the franchisor, then the franchisee appeals, which also leads to delay. In any event, the skirmishes may be fought in two proceedings at the same time. And sometimes it is not clear who is running the ship, so to speak, until certain preliminary issues are resolved. For example, does a judge or an arbitrator decide whether the case should be stayed or dismissed. Looking at this situation from 30,000 feet, can we say that arbitration is effective, less costly and more expeditious—which are the touted virtues of arbitration? The answer: Sometimes yes, and sometimes no.

There are better reasons today for franchisors to favor arbitration over judicial proceedings. From the franchisor's viewpoint, there are now at least two significant advantages in adopting arbitration as the preferred form of dispute resolution. First, there are no provisions for jury trials in arbitration unless the

parties agree to it. Juries, it is thought, will tend to be sympathetic to the franchisee, who in most cases is thought to be the underdog. But there are some franchisees who may be larger than their franchisors.

Second, and more importantly, the franchisor can provide in its agreement that there will be no multi-plaintiff or class action proceedings. Through careful planning, the franchisor can reduce the risk of a mass rebellion by its franchisees. This clearly tips the scales in favor of the franchisor because its disputes with franchisees will be clearly one-on-one, if its franchise agreements eliminate multi-plaintiff and class actions. In contrast, in the judicial world, franchisors might not be able, through contract, to prevent franchisees from bringing class actions or multiple franchisee actions.

Balancing Act

In order to counterbalance franchisor favorable choice of law and forum provisions, several states have enacted laws that make choice of forum and choice of law provisions unenforceable to the extent they may deprive franchisees of their statutorily protected rights. Some state statutes make arbitration clauses unenforceable altogether in certain circumstances, and in some cases the franchisor can require arbitration, but it must be in franchisee's home jurisdiction. It is sometimes hard to predict how the laws of each state will be interpreted and which states will be franchisee friendly or franchisor friendly. Thus, one might ask how much protection do these statutes provide franchisees? Is a choice of law provision a good idea, or a bad one? It could be either.

The key question, however, is whether an arbitration proceeding is more likely to bring adverse consequences to franchisees than a judicial proceeding. To this author's knowledge, there is no empirical research that responds to this question, but there is some anecdotal evidence that the results might not be meaningfully different in judicial and arbitration proceedings based on similar facts.

Arbitration Versus Litigation

Two recent cases² involving the Safeguard Business Systems—one in an arbitration and the other in a judicial proceeding—suggest the difference between litigating a case and pursuing it, instead, in an arbitration setting may not lead to different results. The gravamen of both cases is similar: primarily claims against franchisors for breach of contract, and fraud claims. There were also claims asserted in the arbitration under the Texas Deceptive Trade Practices Act.

According to the plaintiffs' attorney, the facts of each case are almost identical, as much as facts in different cases can be identical. SBS sells office supplies through a network of sales people who fall within the definition of "franchisees." The franchisees solicit business and then submit the orders to SBS. SBS fills the orders and does the billing and most of the other paperwork. Once payments are received by SBS, the salesmen are paid their commissions.

The SBS contract is unusual in that there is no territorial protection for the franchisees. However, the salesmen have customer protection. That is, the salesman who first brings in a customer thereafter receives commissions on all sales to that customer regardless of who solicited the order. The franchisee's customer protection remains in effect as long as a new order from the client is made within three years from the date of the last order.

In 2003, SBS was sold to Deluxe Corporation, a billion dollar plus company that manufactured many of the products that franchisees' customers purchased. Franchisees were encouraged to purchase Deluxe products, but were not required to do so.

In 2013, Deluxe purchased two companies who were competitors of SBS franchisees (the subsidiaries). Many of the customers of the subsidiaries were already customers of SBS franchisees prior to the time the Subsidiaries were acquired by Deluxe, raising the question of who would be paid the commissions on sales made to those companies who were customers of franchisees prior to the acquisition but also customers of the subsidiaries. Deluxe decided that the subsidiaries would receive the commissions on the orders placed by the subsidiaries to these protected customers. To have decided otherwise would have been problematical to Deluxe because Deluxe had included the commissions paid on these sales by the subsidiaries in making their financial forecasts. Sales made by the subsidiaries were more favorable to

Deluxe and SBS because they received all of the revenues from these sales and did not have to pay commissions outside of the Deluxe corporate structure.

When the Safeguard franchises subsequently decided to investigate the payment of commissions by SBS, they were, essentially, stonewalled. The plaintiffs found it nearly impossible to obtain a complete story from SBS, but eventually found that they had been deprived of millions of dollars of commissions for sales made by the Subsidiaries to the franchisees' exclusive customers. In fact, SBS was accused of concealing the actual amounts payable to the franchisees for these sales.

The parties disagreed on how the franchise agreements should be construed, but ultimately the contracts were construed by the court and the arbitrators according to their plain meaning, which favored giving these commissions to franchisees.

There were also claims in both proceedings that SBS had committed common law fraud, but these claims were only pursued in the judicial proceeding. There were also claims asserted in the Arbitration that SBS had violated the Texas Deceptive Trade Practices Act. In the end, the plaintiffs in each proceeding were awarded contractual damages for past sales, loss of future sales, and for fraud (in the arbitration), as well as attorney fees, costs and expenses, but no punitive damages were assessed. In the arbitration case, no punitive damages were awarded because of damage waivers contained in the agreements with the plaintiff in that case. Only the attorney fees award was contested. When the dust settled, the damages in the arbitration proceeding were more than \$4 million and the damages in the court action were in excess of \$6 million.

Conclusion

The takeaway from these cases are two-fold. First, just because a franchisee has to arbitrate a dispute rather than litigate it, is not an overwhelming setback to the franchisee. The franchisee still has the ability to pursue his claims against the franchisor, although the proceeding may occur in a less friendly forum.

Second, franchisees do not almost always lose disputes with their franchisors—a perception often expressed within the franchise community. In this case, facts leading to liability, coupled with excellent performance by the franchisees' counsel, won the day for the franchisees. But victories like this, with significant damages being awarded to franchisees, are few and far between.

Endnotes:

1. R. Barkoff and D. Kaufmann, "Crafting the Perfect ADR Clause," ABA Forum on Franchising (1995).

2. *In the Matter of the Arbitration between T3 Enterprises v. Safeguard Business Systems*, AAA No. 01 15 0002 6860 (Dec. 5, 2006); *T3 Enterprises v.. Safeguard Business Systems*, Case No. CV-OC-1416400 (4th Cir. Id., Sept. 21, 2016).

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