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Arbitration: Is the Silver Bullet a Dud?

By Michael Bowen

For roughly 25 years franchisors have fought hard in courtrooms, in the lobbies of Congress, and at the bargaining table to ensure that that disputes with franchisees would be resolved by arbitration. In large part, they have succeeded. The Supreme Court has repeatedly reaffirmed both the enforceability of arbitration agreements and the desirability of arbitration itself, despite hostile state statutes and stubbornly recalcitrant state courts. Congress has turned a distracted, if not an entirely deaf ear to the efforts of franchisee- and trial lawyer-pressure groups to take franchise agreements outside the protection of the Federal Arbitration Act for all practical purposes. And arbitration provisions have become a standard term in franchise agreements.

Now, however, on the strength of a substantial body of real-world experience with arbitration as a dispute-resolution norm, many franchisors are asking whether all this effort has really paid off after all — whether, in fact, their dogged pursuit of arbitration was actually a mistake. Doubts are emerging because the well-known downsides associated with arbitration seem far more worrisome as concrete realities than they did as abstract analytic factors, and because new concerns have appeared as arbitration has become more common in the franchise universe.

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Ten Rules for Franchisors to Reduce Litigation Risks

Part One of a Two-Part Series

By John Edward Connelly, William L. Killion and Brian B. Schnell

No American commercial enterprise can reasonably hope to enjoy complete, long-term freedom from all litigation. But for franchisors who do business consistent with a few critical (and largely common-sense) rules, freedom from excessive lawsuits and from truly damaging litigation results is not out of reach.

RULE NUMBER 1: FOLLOW THE 'FIVE HABITS OF THE HIGHLY SUCCESSFUL FRANCHISOR'

A franchisor's first and best safeguard against litigation risk is a successful system filled with competent, profitable, empowered (and thereby happy) franchisees. For reasons that go far beyond litigation avoidance, a franchisor wants to run an elite franchise system that leaves it, its franchisees, and its customers fully satisfied.

These "Five Habits of the Highly Successful Franchisor" identify the main philosophies and practices that separate the best franchise systems from the rest:

- Maintain an undying devotion to the brand. A franchisor's brand is more than just a trademark. It is an important tool for communicating to customers. The franchisor must not only protect its brand; it must identify and communicate — constantly — the promise of that brand. The brand promise must be instilled in every aspect of the franchise system.
- Balance the interests of the franchisor, franchisee, and the system as a whole. Highly successful franchisors establish a culture of voluntary compliance with system standards, while vigorously enforcing compliance by errant franchisees to ensure the success of the system as a whole. Franchisors must know when to work out a mutual solution and when to take a stand.
- Stack the deck with "ace" franchisees. Highly successful franchisors understand that franchise recruiting is a separate business from their operational enterprise.

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Downsides Recognized from The Beginning

Franchisors have always known that some thorny risks accompanied the rosy rewards promised by arbitration. The grounds for appealing arbitral awards are sharply limited, and the standards of review are even more rigorous than those governing appeals from judgments entered on jury verdicts. Arbitrators enjoy breathtaking discretion both in conducting proceedings and in making awards. Within extremely broad limits they can allow as much or as little party discovery as they wish, admit or reject evidence from any source and in any form, and (if they wish) write awards that explain nothing. They can consider motions for summary judgment, and sometimes they grant such motions; but they have a significant, immediate financial interest in denying them. The fact that arbitrators (unlike judges), finally, are paid by the parties rather than the taxpayers introduces an additional layer of expense into arbitrable disputes that is far from trivial. The possibility that, for these reasons among others, materially negative consequences could flow from inclusion of arbitration clauses in franchise agreements has pervaded the arbitration debate from the beginning.

Problems Perceived with Experience

Beyond this thoroughly familiar ground, now that franchisors have actually experienced arbitration in a substantial number of disputes, they have found more things to worry about. They have discovered, for example, that many arbitrators are quite prepared to make awards on the basis of "gut" feelings about abstract justice and curbstone equity, even if this requires unapologetic disregard — indeed, defiance — of established law. In plain English, franchisors have found that they lose cases they should have won because awards are sometimes determined by sympathy for the little guy and aversion to hard-nosed profiteering. These are, of course, precisely the vices of juries; but juries are cheaper, and their mistakes are less insulated from effective review. Even more aggravating are errors (or deliberately perverse decisions) on issues of law — errors that could be reviewed under a *de novo* standard if they were made by trial judges, but that are practically bulletproof when they are made by arbitrators, unless the arbitrator committing them is either remarkably dimwitted or excessively candid.

A rather ironic downside appearing in a different way is an emerging judicial backlash against arbitration that appears to be at least in part a reaction to the higher profile that arbitration has assumed as it has become widespread in consumer contracts as well as franchise agreements. The first hints of that backlash were suggestions in Supreme Court *dicta* that arbitration clauses might not be enforceable if the costs imposed on claimants were too onerous. Far more aggressive is a spate of recent holdings in both consumer and franchise cases that arbitration clauses can be struck down as unconscionable if they were imposed rather than negotiated (which of course is almost always the case in the franchise context) and if they are too one-sided.

Many franchisors have reacted to the first facet of the backlash by assuming a grossly disproportionate share of arbitration costs themselves. This dramatically exacerbates the cost disadvantage of arbitration vis-à-vis litigation, in some cases nearly doubling that already substantial expense.

It would be convenient if franchisors could deal with the unconscionability issue simply by avoiding unfair provisions, such as reservation to themselves of a litigation option denied to franchises (although even that course might entail surrender of what many franchisors regard as important protections of their interests). Unfortunately, the standards for unconscionability are, to say it politely, highly qualitative and non-rigorous, and consequently provide limited guidance and have very uncertain predictive value. As a result, drafting arbitration clauses that will pass muster under those standards in hostile courts is no easy matter.

Even more important, the mere availability of the unconscionability argument and its radically indeterminate standards inspires many claimants who would otherwise acquiesce in their duty to arbitrate to challenge arbitrability in court. That tactic forces franchisors into an additional round of sometimes fact-intensive litigation over enforceability before the merits of the substantive dispute are ever addressed. Even when franchisors prevail on the issue of enforceability, then, transactional costs associated with arbitration are once again increased by complex motion practice and sometimes by mini-trials.

In short, many franchise lawyers sold arbitration to their clients as a silver bullet, and many clients who bought that view are wondering whether they have ended up firing blanks — or, even worse, shooting themselves in the foot. Are they on to something? Do the factors outlined above suggest that franchisors should reconsider their commitment to arbitration?

For three interrelated reasons, my answer to that question is an emphatic "No."

First, arbitration still serves its core purpose. That purpose is to minimize the risk of grotesquely aberrant damage verdicts by jurors who collectively imagine that $10 million is pocketchange for a large corporation, and who reject a district sales manager's amply corroborated testimony because the witness wore a flashy Rolex on the stand. That risk is overwhelmingly asymmetrical. One off-the-wall, boxcar verdict can spawn dozens or even hundreds of me-too claims that swell a franchisor's legal expenses and distort its overall financial performance for a decade or more. Such outcomes are far less likely from arbitrators, who may in some cases have perverse intuitions about equity but are seldom as utterly removed from the real world of commercial life

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Movers & Shakers

Five new members will join the Board of Directors of the International Franchise Association next year: Two Men And A Truck CEO **Melanie Bergeron**, CFE; Valpak President **Joseph H. Bourdow**; Sylvan Learning President and CEO **Peter Cohen**; McDonald's U.S. VP of Franchising **John A. Kujawa**; and PIP Printing & Document Services President **Catherine Monson**. The franchise executives will assume their posts during IFA's annual convention in February 2008.

Cheryl Mullin & Associates (Richardson, TX) named a new law partner, changed its name, and expanded its legal team. The firm, now formed as **Mullin House PC**, named **Dyan House** as partner, and has hired three more employees since June. "This year, we've significantly grown our franchise client base, and have expanded our practice areas to meet our clients' needs," said Cheryl Mullin, president and founder of the firm. The firm hired two attorneys this year, **Robert D. Royse Jr**. and **Zachary A. Copp**, and it hired **Laine Schroeder** as senior legal assistant.

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as are many jurors. Avoiding a single outcome of that kind is well worth paying a stack of invoices from the American Arbitration Association ("AAA"), covering the cost of expensive sparring in dozens of motion hearings, and writing checks for the occasional award with one more zero than it should have.

Second, the problems identified above can be mitigated, if not avoided altogether, by careful drafting and a thoughtful strategic approach. Few franchisors, for example, would be willing to forego the right to seek preliminary injunctive relief against misuse of trademarks and misappropriation of collateral securing franchisee debts. No material impairment of franchisor interests would result, however, from making the right to pursue such relief bilateral instead of unilateral. With enough foresight, in fact, the provisions for expedited relief now included in the AAA's Commercial Arbitration Rules can be incorporated into franchise agreements. Those provisions would not eliminate the need for interlocutory judicial remedies, because arbitral awards are not self-enforcing, but they would reduce that need.

Third and most important, whether they are in arbitration or in litigation most franchisor/franchisee disputes are going to settle. Franchisees' lawyers *think* that their prospects in arbitration are far inferior to their chances in front of a jury; after all, that's why they have fought the ferocious anti-arbitration battles that have contributed to the issues discussed in this article. Whether they're right or not is irrelevant. As long as they *believe* that that is the case, the settlement value of a claim in arbitration will be significantly less than the settlement value of a case in litigation. The implication is obvious.

Some might ask at this point whether franchisors could not have the best of both worlds by providing in franchise agreements for waiver of jury trial, thereby forcing all disputes to be tried to the court. Like most litigation tactics, that one is a great trick if it works — but the *if* is a big one. The right to jury trial enjoys sacred status in the American psyche. Arbitration clauses and jury trial waivers both negate that right. The enforceability of arbitration clauses, however, is governed by federal law, whereas the enforceability of jury trial waivers is governed by state law and determined by state judges with scant need to concern themselves with the views of the U.S. Supreme Court on the issue. Any prudent franchisor must assume *a priori* that enforcement of a jury trial waiver clause will be a chancy proposition.

Conclusion

Deciding whether to stick with arbitration or consider an alternative course is not easy. If it were easy, franchisors would not have to pay premium rates to franchise lawyers to help them with that decision. However complex the detail may be, though, the tradeoff between known cost and inherently unknowable risk almost always comes out the same way. My guess is that few franchisors will opt to head back to the jury anytime soon.

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Court Watch

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maintain the status quo until a hearing can be held and, in this case, LGSI was seeking to alter the status quo rather than preserve it. Acceptable reasons for dispensing with notice include where the defendant is not known or could not be located in time for a hearing or where notice would frustrate prosecution of the case, such as where the defendant is likely to destroy critical evidence before the hearing. LGSI did not present evidence of either of these reasons for not notifying the defendants. The court declined to grant the temporary restraining order, scheduled a hearing on the motion for a temporary restraining order for Sept. 25 (11 days after the motion was filed), and directed LGSI to promptly notify the defendants.

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