LAW JOURNAL NEWSLETTERS

LJN's

FRANCHISING BUSINESS & LAW ALERT®

An ALM Publication

Volume 16, Number 10 • July 2010

Contract Litigation

How to Avoid War on Multiple Fronts

By Kevin Martin

In today's world, where it's more competitive than ever to be a franchisor or franchisee, there is now one more thing to worry about: contract litigation. It is more prevalent, complicated, and prohibitive — and worse yet, according to the Bureau of Justice Statistics of the U.S. Department of Justice, one-in-three plaintiffs (33%) lose their contract disputes at trial. From construction contracts, to supply contracts, to equipment leases, franchisors and franchisees might face the problem of litigating numerous legal disputes simultaneously. This, of course, can be devastating for a business, whether big or small. So what can you do to avoid these pitfalls?

First, know your risks. Too often, both franchisors and franchisees assume they are exempt from certain liabilities. Take the recent decision in Massachusetts against the franchisor Coverall North America, Inc., a national commercial cleaning service. It chose to pursue a business model that treated its franchisees as independent contractors, reducing its costs and increasing flexibility, but a U.S. district court judge disagreed. Of course, many have argued that the judge's ruling was overreaching; nevertheless, Coverall was exposed to significant risk.

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Can We Resolve Franchise Disputes Faster, Cheaper and Better?

By Steven K. Fedder, John Lande and Peter R. Silverman

Franchisors and franchisees alike are frustrated with litigation. It costs too much, takes too long, and diverts both sides from their core mission — building the brand. In recent years, we have seen different approaches to alternative dispute resolution, some of which have worked better than others. Even though the vast majority of lawsuits and arbitrations settle before judgment or award, there is an enormous cost and waste of resources involved in the ordinary settlement process. What is needed is a new way to resolve differences between parties that is faster, cheaper, and better.

Resolving franchise disputes early is an important goal for both franchisors and franchisees. Both parties presumably prefer to focus on business rather than litigation, and both have the economic incentive for the franchisee and the entire brand to prosper. If the parties can be convinced that it is in both their interests to enter into candid negotiations before they file suit or demand arbitration, they can avoid wasteful litigation.

Franchisors and franchisees have an additional incentive to resolve disputes before suit is filed because they now must disclose terms of lawsuit settlements in Item III of the Franchise Disclosure Document. Since such disclosures might threaten potential sales of franchises or might provide incentive to other franchisees to pursue similar claims, franchisors should prefer to resolve suits before a lawsuit or arbitration is filed. Further, settling the suit before litigation is filed gives the franchisor more discretion on settlement terms because the terms can be confidential. This also provides possible leverage for franchisees in seeking resolution before litigation is filed.

Traditional ADR: Benefits and Limitations

Since the enactment of the Federal Arbitration Act, courts have favored the use of arbitration as a means of resolving disputes short of litigation. Unfortunately, arbitration now too often looks too much like litigation, especially when extensive

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Resolve Disputes

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discovery occurs. Also, numerous franchisors and other businesses have experienced protracted battles in court or the arbitration over the scope and fairness of arbitration clauses, whether limitations on class actions are enforceable, who can award attorneys' fees, and the availability and scope of judicial review.

Many franchise agreements now provide for mandatory pre-suit mediation, but there is no consensus on whether mandatory mediation clauses should be used in franchise agreements. Franchisors and franchisees who want to settle and who have good lawyers will know when a dispute is ripe for resolution, and mediation can be very successful if both parties proceed in good faith. But if those factors are not present, mandatory mediation can be a waste of time and money.

Also, once suit is filed, parties often choose to mediate, or courts will order it. But this frequently occurs only after parties have spent a lot of time and money and have learned little more than they knew at the suit's inception.

Recognizing the inherent weaknesses in traditional ADR, scholars and lawyers are developing new techniques to refine and improve the process. A number of different approaches have been evolving over the years, which we identify collectively as "Planned Early Negotiation."

A New Direction

Lawyers have developed several processes addressing the problems of unplanned negotiation that occur late in a lawsuit. These "planned early negotiation" processes — "collaborative practice," "cooperative practice," and "settlement counsel" — encourage lawyers and parties to focus on negotiation early in a matter, preferably before a party has filed suit. These are voluntary processes that require the parties to get serious about negotiation from the outset.

The lawyers for each party begin by assessing whether the matter is appropriate for early negotiation and discussing this with their clients. If the clients want to use one of the processes, the lawyers work together to plan the procedure. The processes generally involve one or more face-to-face negotiation sessions with the parties in the dispute, as well as with their lawyers.

One of the most important parts of the procedure is having a plan for the exchange of information so that both sides can reasonably evaluate their respective positions. Instead of bombarding each other with burdensome, overbroad discovery requests, the lawyers agree to promptly and voluntarily exchange the critical information. Only rarely do these exchanges uncover a "smoking gun" document that one side wants to hide; the documents are generally a small subset of documents that would otherwise have to be produced in the course of discovery.

After the parties have exchanged information, they use interest-based negotiation ("IBN") to develop a solution that works for both sides. This involves discussion of each side's interests and creative problem-solving to look for positive-sum solutions where both parties satisfy important interests. IBN allows the parties to consider issues such as confidentiality and business reputation, establishment of new procedures, and prevention of ancillary harm (such

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Telephone: (877) 256-2472
Editorial e-mail: jgromer@alm.com
Circulation e-mail: customercare@alm.com
Reprints: www.almreprints.com

LJN's Franchising Business & Law Alert 023145
Periodicals Postage Paid at Philadelphia, PA
POSTMASTER: Send address changes to:
ALM
120 Broadway, New York, NY 10271

Published Monthly by:
Law Journal Newsletters
1617 JFK Boulevard, Suite 1750, Philadelphia, Pa 19103
www.ljnonline.com

Resolve Disputes

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as loss of credit rating or business opportunities). Early settlement itself is a positive-sum solution, given that it saves litigation costs, eliminates uncertainty, and allows parties to return to focusing solely on business. This contrasts with zero-sum negotiation at the end of litigation where each party's gain is the other party's loss — and both sides incur large legal bills.

IBN lends itself well to franchise cases because in many disputes, the franchisee continues to do business with the franchisor; therefore, early interest-based resolution of the dispute should serve as a platform for a better relationship. Even in termination cases, the parties have an ongoing relationship because terminated franchisees often voice their anger publicly, and they are listed in the FDD. An interest-based resolution can lessen the animosity stemming from ending the franchise relationship.

The parties may use mediators, experts, neutral evaluators, or other professionals to assist in the negotiation.

Collaborative practice is now used almost exclusively in family law cases, but it can be effectively applied to business disputes. In collaborative practice, both parties hire lawyers who have limited the scope of their representation in the matter to negotiation. The parties and the lawyers sign a "participation agreement," which provides that the parties and lawyers focus solely on using IBN to resolve the issues. The participation agreement includes a "disqualification" provision stating that if either party wants to use contested litigation, both lawyers are disqualified from representing the parties in litigation. If the parties want representation in litigation, they must hire new litigation counsel. This disqualification provision creates an incentive for everyone to work hard to settle the matter.

A variation on this process is referred to as "cooperative law." The key difference is that, while the parties initially pursue settlement using the same cooperative negotiation principles, the lawyers are not disqualified from litigating. This may be more efficient, though the parties and lawyers might not be as committed to resolution through negotiation.

"Settlement counsel" is a related process that is more commonly used in business disputes. Any party may hire a lawyer solely for negotiation, regardless of whether the other side also hires settlement counsel. When parties engage settlement counsel, they may or may not also simultaneously engage litigation counsel. If so, this could be handled in a number of different ways. Inside counsel could serve as settlement counsel, and outside counsel could serve as litigation counsel. Or one lawyer in a firm could serve as settlement counsel, and another lawyer at the firm could serve as litigation counsel. Or settlement and litigation counsel could be from different firms. Compensation can come into play if, for example, the client offers incentives to settlement counsel for resolving the dispute early.

Early Active Intervention

Co-author Peter Silverman has developed a process that he calls Early Active Intervention ("EAI") to tailor a cooperative process to franchise disputes. EAI involves a voluntary effort on both sides to resolve the dispute as early, quickly, and inexpensively as possible. The parties can use a facilitator, who can structure a limited information exchange if a case is not ripe for resolution, which many mediators don't do. Then the facilitator helps parties and lawyers work out an agreement.

See model EAI clause for franchise agreements on page 4.

Conclusion

Franchisors and franchisees need faster, cheaper, and better ways to resolve disputes. Planned early negotiation processes and early active intervention clauses can help parties and lawyers achieve these goals.

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Avoid War

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Beyond employment and compensation issues, another common area of poor risk management is arbitration clauses. While found in many contracts, such clauses do not guarantee you won't end up court. For example, the Ninth Circuit in *Nagrampa v. Mailcoups Inc.*, 469 F.3d 1257 (2006), found that an arbitration between a franchisor and a franchisee was both procedurally and substantively uncontainable.

Regardless of the validity of the *Coverall* ruling or the specifics of an individual arbitration clause, the point remains the same: The better you understand your risk exposure as a franchisor or franchisee, the less likely you are to end up with liability.

Another development altering the risk landscape for franchisors and franchisees is the growth of predominately "loser pays" jurisdictions and the spread of "loser pays" or prevailing party provisions. (Loser pays provisions are, of course, borne out of the English model, where the plaintiff is required to pay the adversary's legal fees in the case of an adverse ruling.)

Numerous mini "loser pays" systems are emerging in the United States, such as in Oregon and Alaska. As a result, a franchisor with a regional footprint needs to be aware of the full extent of its liabilities if it sues a franchisee and loses. Similarly, franchisees should take the existence of "loser pays" systems into account when deciding to do business. Regrettably, both the legal and business communities have been paying little

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Model Early Active Intervention Clause for Franchise Agreements

Early active intervention. If either of us has a claim against the other that we have not been able to resolve through unstructured negotiation, either of us may invoke early active intervention ("EAI") to commence structured negotiation before filing [suit or arbitration]. EAI is subject to the following rules:

1. *Initiation of the process.* You or we initiate EAI by sending notice (the "Notice") to the other party that states that the initiating party is initiating EAI, and that provides a concise statement of the claim.

2. *Tolling.* Initiation of EAI tolls the statute of limitations on the initiating party's claims. The other party may terminate tolling on 14 days' notice.

3. *Response.* Within 7 days of receiving the Notice, the other party shall send the initiating party a statement whether the other party will participate in EAI and, if so, a concise substantive response (the "Response") to the initiating party's claim.

4. *Direct negotiation.* You and we may (but are not required to) begin direct negotiations within 3 days of the receipt of the Response. We shall use effective negotiation principles as follows:

i. *Parties with authority.* We will each arrange for attendance at the negotiation of the people on our respective sides who have the authority to resolve the dispute.

ii. *Goal and principles.* The goal of negotiation will be to seek a business resolution of the dispute through cooperative communication. We shall focus on each other's most important interests, seek to generate options to satisfy those interests, and consider possible objective standards to evaluate interests and options.

iii. *Need for further information or documents.* If the dispute is not resolved at our initial negotiation session, we shall determine whether either party needs further information or documents to reasonably evaluate the issues. If either side needs such information or documents, we shall set a time period for exchange of information and documents. Normally, this period will be no more than 30 days after the date of our agreement.

iv. *Further negotiation.* If we agree to continue negotiation following information and document exchange, negotiation shall begin within 14 days after completion of the exchange.

5. *Selection of EAI facilitator.*

i. *Timing.* At any time, if we believe that a neutral facilitator would assist us in negotiation, we shall mutually and promptly select an EAI facilitator.

ii. *Fees.* We will each be responsible for half of the facilitator's fees.

6. *Case facilitation process.* Within seven days of the facilitator's selection, the facilitator shall hold a case facilitation conference by telephone. The conference shall address the following topics:

i. *Information and document exchange.* If we have not agreed on exchange of information or documents, the facilitator may decide on the appropriate scope of information and document exchange. The presumption shall be to require only that discovery necessary to give the parties enough information to reasonably evaluate the merits of our respective positions. The facilitator shall set a short time limit to finish exchange of information and documents. Normally, this exchange will be completed no later than 30 days after the telephone case facilitation conference.

ii. *Facilitation schedule and site.* The facilitator shall set a date for a face-to-face case facilitation conference. The conference shall be scheduled no later than 30 days after the end of information and document exchange. The facilitator shall decide the place of the conference after consulting with us.

iii. *Facilitation conference.* The facilitator may require us to submit materials to the facilitator that we send confidentially to only the facilitator and/or that we share with each other. We will each arrange for the attendance at the conference of the people on our respective sides who have the authority to resolve the dispute. The facilitator's role will be to actively mediate the dispute with the goal of seeking resolution.

iv. *Litigation management.* If we are unable to resolve the dispute at the conference, the facilitator shall assist us in developing a litigation management agreement to cover discovery, time limits, and other matters to seek to limit the cost and time of [suit or arbitration].

v. *Flexibility.* The facilitator shall have the discretion to alter these rules as the facilitator sees fit.

7. *Method of written communication.* All written communication shall be by e-mail. For purposes of calculating dates, receipt of written communications will be deemed contemporaneous with sending.

8. *Modification of the process.* If the facilitator believes that modifying the procedure is appropriate, the facilitator may do so after consulting with the parties.

9. *Voluntary termination.* Either party may terminate the EAI process at any time by sending three days' notice to the other.

Source: Peter R. Silverman (psilverman@slk-law.com)

COURT WATCH

By Darryl A. Hart
and Charles G. Miller

Class Action Waivers in Franchise Agreements Are Enforced

Just when everyone has been thinking that franchisors will have a difficult time enforcing class action waiver clauses, two recent cases have indicated that such clauses are alive and well. In a recent California Court of Appeal decision, *Gold v. Melt Inc.,* Cal. Ct. App., 2d Dist., Bus. Franchise Guide (CCH) ¶ 14,371 (Apr. 16, 2010), certified for non-publication, a three-judge appellate panel affirmed the trial court's determination that a class action waiver contained in a gelato ice-cream franchise was enforceable. (The designation "certified for non-publication" means that the case cannot be cited as authority to any other California state trial or appellate court. However, the case is unofficially published. *See, e.g.,* WL 1951145.)

While the *Gold v. Melt* decision is officially unpublished, it nonetheless is worthy of discussion as indicative of how a California Court of Appeal is likely to rule in another similar case in the future. The issue was decided on the pleadings and affirmed the trial court's order sustaining a demurrer without leave to amend. No argument was raised regarding the possible impact of California Civil Code S1670.5, which affords a party challenging a provision as unconscionable a "reasonable opportunity to present evidence as to its commercial setting, purpose, and effect to aid the court in making the determination."

Because of different choice of law clauses in the various franchise agreements in issue, the court concluded that the class action waiver provisions were not unconscionable under California, Florida, or Massachusetts law.

The franchisees first claimed that the trial court had wrongly decided there was no procedural unconscionability because of a five-day "cooling off" period, referencing the provision that required the agreement to be presented to the franchisee at least five days before execution. The appellate court rejected this argument because the trial court did not dispense with the need to consider substantive unconscionability, but simply held that the five-day waiting period reduced the procedural unconscionability to the bare minimum. Nonetheless, franchisors should take note of that argument as a way to reduce procedural unconscionability and require that a plaintiff must show a great degree of substantive unconscionability. While the waiting period certainly undercuts the element of surprise, it still may not do away with the superior bargaining power of the franchisor in assessing procedural unconscionability.

In determining that the class action waiver provision was not substantively unconscionable under California law, the court ruled that *Discover Bank v. Superior Court,* 30 Cal.Rptr.3d 76 (2005), a leading case that struck down a class action waiver provision in a consumer credit card agreement, should be limited to consumer contracts involving small sums in dispute. The court in *Discover Bank* held that enforcement of a class action prohibition could be viewed as an unlawful exculpatory clause where it has the effect of allowing the defendant to commit fraud on a large number of people who, because of the small individual recovery, would likely only challenge that conduct in a class action. The *Gold* court held that franchise agreements do not resemble consumer contracts and pointed to the large amounts of money involved in the dispute.

However, The franchisee's reliance on *Postal Instant Press, Inc. v. Sealy,* 51 Cal.Rptr.2d 365 (1996), which struck down a franchisor's attempt to collect future royalties on termination, did nothing to shake the court's view that the franchise agreement resembled a consumer contract. While the court cited *Independent Association of Mailbox Center Owners, Inc. et al. v. Superior Court,* 34 Cal. Rptr.3d 659 (2005) ("*Mailboxes*"), for general principles pertaining to unconscionability, it did not at all mention that in that case, another court of appeal panel of a different appellate district held that a class action/consolidation waiver provision in a franchise agreement was unconscionable. The basis of the court's ruling in *Mailboxes* was that franchise agreements have the same characteristics as adhesion contracts in the consumer and employment fields, and enforcement of class action or consolidation waivers would implicate public policy of the franchise-protection statutes.

The result was the same under Florida law. The only Florida cases striking down class action waivers involved consumer contracts, *S.D.S. Autos, Inc. v. Chrzanowski,* (Fla. App. 1 Dist. 2007) 976 So.2d 600 (auto leasing contract) and *Powertel, Inc. v. Bexley,* (Fla.App. 1 Dist. 1999) 743 So.2d 570 (cellular phone contracts) and were not applicable to franchise agreements.

For Massachusetts, the plaintiffs principally relied on *Skirchak v. Dynamic Research Corp.* (1st Cir. 2007) 508 F.3d 49, which struck down a class action waiver in an employment case. The court distinguished *Skirchak* because of the high degree of procedural unconscionability (the provision was hidden in an e-mail sent to employees two days before Thanksgiving) and because it attempted to waive a statutory right to bring that type of action as a class action. The court

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Court Watch

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noted that franchisees had no statutory right to bring cases as class actions in Massachusetts.

Reconciling *Mailboxes* with *Melt* in California may not be that difficult. While franchise agreements are clearly not consumer contracts, as noted in *Mailboxes*, they still may have the attributes of adhesion contracts. That, however, only allows the court to next consider whether a class action waiver is substantively unconscionable. In order to do so, a court does not only have to find that the provision acts as an exculpatory clause. The other legal theory under which class action waivers can be invalidated is that enunciated by the California Supreme Court in *Gentry v. Superior Court,* 64 Cal.Rptr.3d 773 (2007). *Gentry* held that a class action waiver could be struck down in an employment case if the court determined that a class action is a significantly more effective and practical means of vindicating unwaivable statutory rights. *Mailboxes* preceded *Gentry*, but its holding is similar to the extent that consolidated or class actions might be the only practical means that franchisees have to assert their rights under the California Franchise Investment Law. To come to that conclusion, of course, a court would have to engage in an extensive factual analysis with regard to the nature of the claims and the viability of bringing them as individual claims. When all is said and done, it may not be enough for a franchise to simply argue that franchise agreements are not consumer contracts in order to uphold class action waivers.

Illustrative of the type of factual showing needed is a recent case from the East Coast, *Reid v. Supeshuttle International, Inc.,* Bus. Franchise Guide (CCH) ¶ 14,358 (E.D. N.Y. May 22, 2010). There, the franchisees argued that arbitration would be prohibitively expensive unless they were able to seek class relief and would thus allow the defendant to continue its allegedly unlawful practices. The problem with this argument, noted the court, was that it was largely just that — argument — without any factual support. In order to prevail on such an argument, the plaintiffs would need to produce expert testimony about the cost of arbitration and show that individual litigation would be cost-prohibitive.

Choice of Law Clause May Not Apply Absent Independent Jurisdictional Elements

In *Red Lion Hotels Franchising, Inc. v. MAK, LLC et al.,* __ F. Supp. 2d __ USDC, BFG ¶ 14,367 (Eastern District of Washington, March 15, 2010), the plaintiff hotel chain sued a former franchisee for unpaid royalties and liquidated damages after the franchisee's agreement was terminated for not complying with the franchisor's property-improvement requirements. The defendant franchisee counterclaimed, alleging that the termination violated the Washington Franchise Investment Protection Act's ("the Washington FIPA") relationship law, RCW § 19.100.180, which in turn constituted a violation of the Washington Consumer Protection Act, RCW §§ 19.86.010 et seq.

The plaintiff is located in Spokane, WA. The defendant operated a hotel in Modesto, CA. The franchise agreement specified that Washington law would apply to the agreement except for Washington franchise law, unless that law applied independent of the reference to Washington law in the agreement.

The defendant hoped to apply the Washington relationship law rather than the California Franchise Relations Act ("the CFRA"), Cal. Bus. & Prof. Code §§ 20000 et seq., which clearly applies to a California-based franchise, because a violation of the Washington franchise law would permit the recovery of treble damages and attorneys' fees. The only remedy provided by the CFRA is that the franchisor of a wrongfully terminated franchisee must offer to repurchase the franchisee's current resale inventory. The CFRA does not prevent a franchisee from pursuing contract damages for wrongful termination, but common law contract damages would not include treble damages or attorneys' fees absent an attorneys' fees provision in the franchise agreement.

In a motion by the plaintiff seeking a partial summary judgment to dismiss the defendant's Washington-law claims, the defendant franchisee argued that while some of the sections of the Washington FIPA provide that they apply only to activities "in this state," the relationship provision does not contain such a limitation. As such, argued the defendant, since the plaintiff was based in Washington, and, therefore, the transaction had a substantial relationship with that state, its law should apply as selected.

The court examined the overall statutory scheme of the Washington FIPA to determine whether the Washington legislature intended to confine its reach to franchises operating in that state, or whether it intended the Washington FIPA to have a broader reach. One assumes the franchisee also argued that if the Washington FIPA has extraterritorial reach, it would override the limitation on the application of Washington franchise law in the franchise agreement.

The court concluded that the statute as a whole evinced an intent to apply only to franchises located in Washington, whether or not a specific section referred to "in this state." As such, a California franchisee whose business is located in California could not benefit from the Washington FIPA, but must rely on the CFRA's more limited remedies and California's general contract remedies. The Washington-law claims were, therefore, dismissed.

The lesson of this case is to use extra care when drafting choice-of-law provisions and to make clear, if the law itself does not do so, under what circumstances the chosen law will or will not apply.

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NEWS BRIEFS

FRANCHISOR TAX NEXUS CASE REACHES IOWA SUPREME COURT

In a case with potentially significant implications for taxation of franchisors, the Iowa Supreme Court heard oral arguments on May 20 in *KFC Corporation v. Iowa Department of Revenue*. "A victory by the state would represent an extension of [*Geoffrey v. South Carolina Tax Commission*, 313 S.C. 15 (1993), and other similar] cases because *KFC Corp.* involves licensing agreements between unrelated parties," said Bruce Ackerman, of counsel, Faegre & Benson LLP (Minneapolis), who is not involved in the litigation. "The *KFC* case could result in a landmark decision for states attempting to impose income tax on out-of-state franchisors and other similarly situated taxpayers. This would be the first contemporary case to reach a state supreme court and directly address the franchisor-franchisee relationship."

The issue is whether *Quill Corp. v. North Dakota*, 504 U.S. 298 (1992), will dictate the case or whether the court will follow the *Geoffrey* line of cases in holding that *Quill* does not limit the state's power in this area. *Quill* held that the Commerce Clause of the U.S. Constitution barred states from imposing a use-tax collection obligation on out-of-state corporations that had no physical presence in the taxing state — that the corporations lacked the "substantial nexus" with the state that was required under the Commerce Clause. But states have not stopped seeking to capture that tax revenue, and *Geoffrey* has been their opening to argue that they can impose an income tax on an out-of-state licensor whose only connection with the state is the receipt of royalties from use of its intangible property in the state.

In June 2009, in *KFC Corporation v. Iowa Department of Revenue*, an Iowa District Court upheld the state's imposition of a corporate income tax on KFC based on its receipt of royalties from franchisees in the state. "The court held that the Commerce Clause of the U.S. Constitution did not require a taxpayer to have a physical presence in Iowa to establish a 'substantial nexus' in the state for purposes of corporate income tax," said Adam B. Thimmesch, associate, Faegre & Benson. "The district court cited to the *Geoffrey* line of cases to support its decision."

KFC appealed to the state supreme court. "KFC forcefully argued that *Quill* should apply to Iowa's corporate income tax and that the *Geoffrey* line of cases had been improperly decided," wrote Ackerman and Thimmesch after watching the oral argument. "The state appeared content to rely on the *Geoffrey* line of cases during its argument."

However, Ackerman and Thimmesch said that KFC ran into skepticism from the court. "The court stated that it struggled with the notion that the Commerce Clause protected KFC from taxation in the state even though KFC earned significant income in Iowa that was dependent upon the state's provision of protections and benefits to its franchisees (*e.g.,* roads, courts, etc.). KFC responded by arguing that those indirect benefits were received by many out-of-state (or out-of-country) entities whose products or customers happened to be sold or located in Iowa. According to KFC, if the court applied that type of indirect-benefit analysis, 'everyone would be taxable everywhere,'" they wrote.

If the court decides in favor of Iowa, other states will likely be emboldened in seeking to collect income taxes from franchisors, said Thimmesch. Franchisors that have not been filing returns in the state could be liable for taxes, interest, and penalties, he added. "We would advise franchisors to discuss this issue with their tax advisers and to determine how they will respond in the event of an adverse decision, especially if they operate in Iowa, do not file returns in the state, and have not already been contacted by the state," he said.

If *KFC Corp.* is decided favorably for KFC, the case may discourage actions by other states against out-of-state franchisors, Ackerman added. "Franchisors should keep in mind, however, that other states will not be bound by KFC Corp. and other state taxing authorities may attempt to obtain a more favorable ruling in their state courts," he said.

FRANCHISEE-EMPLOYEE STATUS UNRESOLVED AS JUDGE DISMISSES CLAIMS IN *AWUAH V. COVERALL*

In a three-week trial, U.S. District Court Judge William G. Young dismissed all claims filed by three Massachusetts franchisees of Coverall North America, Inc., who were claiming status as employees of the franchisor. However, the judge's decision did not reflect a reversal of his decision in March 2010 that found that Coverall franchisees are, in fact, employees under Massachusetts law. The judge's finding in March, combined with his comment that likened franchising to a Ponzi scheme, raised concerns among franchisors about massive increases in their liability for many actions by franchisees and employees of franchisees.

"The jury did not get to decide on the merits of the case; it was thrown out only on technical grounds," said Shannon Liss-Riordan (Lichten & Liss-Riordan, P.C., in Boston), attorney for the franchisees. "Two were thrown out because franchisees had signed releases, and the other had passed the statute of limitations. Several times during the trial, the judge repeated that his ruling on summary judgment stands [that the franchisees can be considered employees in Massachusetts]."

Liss-Riordan has refiled for class certification under state law for

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MOVERS & SHAKERS

Stephen J. Caldeira has been named president and chief executive of the **International Franchise Association**, succeeding **Matthew Shay**, who is now president and chief executive of the **National Retail Federation**. Caldeira was executive vice president of global communications and chief public affairs officer for **Dunkin' Brands Inc.**, and he has held executive positions at the **National Restaurant Association**, **PepsiCo Inc.**, and **Burson-Marsteller**.

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recognition of the franchisees as employees and a national class action for unfair and deceptive trade practices. As of press time, Judge Young had not made a decision on class certification.

"The issue isn't franchising in general. There are many ways to be a franchisor in Massachusetts that are not like what Coverall has done," said Liss-Riordan. "But Coverall obtained the contracts and then delegated the work to 'franchisees,' just like a company would delegate work to its employees. Basically, the franchisor was acting as if it could put the 'franchise' label on the relationship and avoid designation as an employee relationship."

Meanwhile, Coverall noted in public statements that the franchisees failed to present proof that they had suffered any damages as a result of the alleged misclassification and that it is considering filing for attorneys' fees and costs.

MD AMENDS FRANCHISE LAW TO GET RID OF FIRST PERSONAL MEETING REQUIREMENT

Effective on Oct. 1, 2010, the Maryland Legislature amended § 14-223 of the Maryland Franchise Law to change the timing for delivery of the Franchise Disclosure Document ("FDD") from "10 business days" to "14 calendar days" before a prospective franchisee pays any money or signs an agreement related to the franchise sale. In addition, the Maryland amendment replaces the "first personal meeting" requirement with a requirement that the franchisor deliver the FDD "upon the prospective franchisee's reasonable request." The Maryland amendments make Maryland's franchise delivery rule consistent with the FTC's 2007 Amended Franchise Rule.

Avoid War

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attention to this steady but significant change to American legal habits. Some would argue this trend discourages frivolous claims, and while that would be a positive outcome, it still remains an area of risk exposure.

HOW TO HEDGE AGAINST RISK

As any good businessman knows, effectively managing your risk can be the difference between a profitable and unprofitable year. There are several steps that franchisors and franchisees can take to increase the chances of prevailing in suits. First, the importance of jurisdiction is often underestimated. If you are bringing a suit, is there a choice of where to file the case? Which courts are congested? What is a reasonable estimation for a time to trial? Which registration states are going to limit your venue to their courts? These facts are important to know, as an expedited resolution greatly reduces risk exposure compared to a far-off trial date.

Second, once a complaint has been filed and a judge assigned, it is crucial to learn as much about the jurist as possible. Obtain judicial profiles of your judge. Seek information from lawyers with experience litigating before your judge. It is also important to understand your judge's practices and attitude toward demurrers, summary judgment motions, motions in limine, and other critical pre-trial matters. Has your judge made prior rulings on the kinds of contractual disputes at issue? Are there any appellate decisions involving your judge's rulings at trial?

Third, research the elements of your claims and make sure you have the facts to satisfy each element. This may sound like "Litigation 101," but in a franchise system that might be facing several litigation proceedings simultaneously, this can often get overlooked.

Lastly, staying up-to-date on the latest risk-management tools and best practices will ensure that franchisor and franchisee have all possible resources available at their disposal. For example, today there are insurance policies available to cover attorneys' fees awarded under "loser pays" provisions. This contract litigation coverage can be purchased within 60 days of the commencement of litigation and covers all attorneys' fees in an adverse ruling.

Franchisees and franchisors face risks on multiple fronts, including litigation. But by taking steps to prepare for and mitigate liability, the business will be in a better position to grow and thrive.

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