

APPLYING MEDIATION AND ALTERNATIVE-DISPUTE RESOLUTION TECHNIQUES TO FRANCHISE BUSINESS RELATIONS

Brand strength requires broad representation in major markets, and franchise executives must answer increasing pressure to sharpen their company's competitive edge and generate business leads that add units to the chain and improve profit margins. It might seem anomalous, but implementing a conflict resolution policy focused on business-oriented settlements of disagreements with franchisees is viable corporate strategy for system growth and prosperity.

The franchisee/franchisor relationship – the lifeblood of any franchise system – turns on mutual trust and reciprocal duties of performance. Franchisees expect the franchisor to enforce consistent system standards and judiciously use pooled funds for national and regional advertising. Franchisors need franchisees to represent the brand to consumers in a manner consistent with the desired brand image, and accurately report revenues and timely pay royalties for use of the brand name and franchise system.

A contractual franchise relationship can span between one and twenty years. To maintain well functioning relations over such long time-period requires a tolerance for episodes of respectful disagreement and reasonable compromise to get past issues that naturally arise in the course of commercial dealings. This section illustrates how the business of franchising is a paradigm for the use of conflict resolution practices and mediation particularly, and gives a basic framework from which to build alternative dispute resolution processes into the fabric of a business.

PRE-LITIGATION DISPUTE ALTERNATIVES

Before suing a franchisee for breach of contract, a franchisor lawyer and his client should consider the discernible as well as the intangible cost and benefits of taking such action. A basic tenet of franchising holds that to succeed a franchise company needs sustained system growth and positive brand recognition in strategic markets. Thus a company should carefully consider any action that could end a relationship with a franchisee and reduce market presence and eliminate a perpetual revenue stream. Of course, if a franchised unit is not paying royalties and fees when owed, and poorly represents the image of the brand in a market, the franchisor may be constrained to end the relationship. Even in those circumstances, however, the size a dispute might not justify the expense of time and money to resolve the problem through litigation. But when the amount in controversy is adequate to justify the cost and risk of litigation, franchise lawyers should assist their clients on weighing the benefits of using alternatives to litigation.

A franchisor can optimize system growth with a strategy to retain existing franchises and well thought-out sales efforts. The addition of incremental new business coupled with responsible franchise retention will expand a chain and increase brand recognition by creating a cluster of units in a concentrated region. Franchise site retention occurs when the franchisor has an opportunity to but does not terminate a relationship and instead looks for constructive ways to save units. An active and organized sales force versed in the brand's product or services will undoubtedly bring new business to a franchisor. Growth may only be as good as the quality of the units

added, as bringing in new units that are doomed to failure will not advance system development. The franchisor needs a sound franchise-review process to ensure that new units entering the chain have the capacity to flourish and duly represent the brand for the duration of the contract term.

Retaining a franchise must be justified in the circumstances, and not every business relationship can or should be saved. There are conditions, however, where a business combination degenerates from negative events beyond the control of the parties. It is those circumstances where informed intervention by the franchisor could save an existing relationship and even build good will for future relations. Such a proactive approach requires a corporate awareness with acumen on how to win over the long term with competing franchise systems – growth and prosperity through relationship building and not instant gratification through enforcing damages provisions when franchisees nominally breach their contracts.

Ordinary communication can save a failing franchise relationship. Suppose, for instance, a hotel brand franchisee at a resort location suffers property damage from a flash flood. The franchisee, which has no business interest other than the hotel, carries general liability insurance but no coverage for loss caused by water damage. The franchisee must close a section of the hotel for repairs, which will require financing for the necessary capital improvements. Meeting the loan obligation will shrink the franchisee's margins and put a strain on cash flow.

Without communicating this problem to the franchisor, the franchisee unilaterally decides to reduce his royalty payments in order to free up limited funds. The arrears mount and the franchisor's finance department sends the franchisee a notice of monetary

default and restricts the franchisee's access to the brand's central reservation system. Unable to book business through calls from the nationally advertised toll-free number, which normally generates close to twenty percent of the franchisee's monthly room rentals, and irate from the apparent insensitivity to his difficulties, the franchisee stops reporting revenues and ceases payment of any royalties. A franchisee's chronic non-payment of royalties is a default under the franchise agreement, subjecting the franchise to termination if not timely cured.

Before taking action to terminate the franchise, which could result in costly and unproductive litigation, the franchisor still has an opportunity to save the relationship. By setting up a meeting or conference call and getting to the bottom of what might be motivating the franchisee's conduct, the franchisor will be positioned to strike a compromise and give the franchise relationship a chance to survive past the present difficulties. This approach may require using different areas of expertise within the company or exploiting the franchisor's business alliances with third parties that may be able to help the franchisee. For example, the franchisor might use its purchasing power to facilitate arrangements with lenders to offer financing at competitive rates or with contractors for renovation work. Franchise design and finance experts within the company, respectively, can offer assistance in these fields.

The franchisor also may need to evaluate the situation independently before approaching the franchisee about a proposed resolution of the problem. First, the franchisor will need to inspect the hotel and prepare a punch list for the renovations. The punch list will contain an estimate of costs and establish a reasonable timetable for completing the work and bringing the damaged rooms back into the system. Second, the

franchisor will need to be satisfied that the franchisee indeed has cash flow difficulties, which could be learned, if necessary, through an independent audit or asset check. With better knowledge of the situation, the franchisor will be in a position to offer a temporary royalty reduction in exchange for a commitment to complete the renovations by a date certain.¹ If the franchisee accepts the proposal to use a work out plan with a temporary royalty reduction, the legal department can draft an amendment to the franchise agreement to alter the royalty obligation, attach the work out plan as an exhibit, and prepare mutual releases.

To ensure that a troubled franchise has the best chance to survive and not get lost in the corporate shuffle, a franchisor should establish a review council specifically charged with franchise relationship building and problem solving. A franchise review board, with a cross section of experts from inside the franchise company, can focus on retention and helping franchisees succeed. In that setting, the franchisor can combine the respective expertise of personnel with operational, finance legal and quality standards to formulate a constructive approach to a problem. Armed with the resolve of the organization, a company spokesperson can arrange a meeting or conference call with the franchisee, present the options available and try to establish a plan with the franchisee or report back to the company that efforts were unsuccessful. Before terminating the relationship, however, the company should consider with the advice of counsel more formalized dispute resolution techniques, including the involvement of a neutral third party to mediate the dispute.

¹ A royalty reduction will avoid having to require the franchisor to advance cash for the franchisee and is often a more desirable means of support, as it does not require repayment terms or additional contractual obligations. Some franchisors may have interest or low interest loan programs available, which may require a promissory note and repayment obligation.

PRE-LITIGATION MEDIATION

The conflict management practice described above may save a franchise relationship or at least rekindle a positive association between the parties. But not every story will lead to an uneventful and mutually satisfactory ending. The franchisee may feel as if the timetable in the franchisor's proposed work out plan is too ambitious and want the franchisor to agree to eliminate all royalty payments until the work is completed. Similarly, the franchisee may decide not to allow an inspection or verification of its financial difficulties, in which case the franchisor may not be inclined to offer a work out plan and royalty reduction in the first place. In instances where the parties agree to disagree but are open minded to a process that will help them settle their differences, mediation may be appropriate. If preserving the relationship is a paramount concern, and it should be from the franchisor's perspective for the reasons discussed, it is critical to use a forum where the parties can vent emotions while having the best chance to align their common interests.

Notwithstanding the obvious benefits of mediation, it can be inexplicably difficult to convince a franchisee (or even their lawyer) that referring a conflict to a neutral, third party is an intelligent use of time and money. If a problem can be resolved in one day of negotiation and the parties can come away from the experience with little if any residual animus between them, mediation should most always be considered prior to filing suit. Indeed, one could make a good argument that there are only two situations where mediation should not be considered: (1) if there is a need to create a judicial precedent or (2) if the other side will not settle. Over ninety percent of all lawsuits settle before trial. It behooves parties to a dispute, therefore, to find a way to compromise their position and

settle a dispute without litigation. If parties to a conflict recognize this basic notion, they will understand that filing litigation without considering mediation will likely result in wasted time and resources.

One of the parties may decide to file a lawsuit, but that act will merely defer the inevitable; at some point the parties will likely settle their disagreement. There may be circumstances, for instance, where one of the parties wants to mediate but also wishes to control the forum and be the first to file suit in case the matter does not settle. One difficulty with such an approach is the risk that filing the suit will alienate the other side, create a set back in negotiations, and cause each side to incur litigation costs during the cooling off period. This is particularly true for cases filed in federal districts where initial disclosure rules might cause parties to bear more front-end burden and expense.

Contentious litigation will interfere with the facility of the parties to understand the wisdom of the premise that those involved in the dispute – not a “trier of fact” -- should dictate the terms of the outcome. Launching straight into litigation without stopping to consider that most cases settle before trial demonstrates a failure to see the numerous benefits naturally realized when disputants reduce the amount of time taken to settle their legal differences. The unfortunate reality, however, is that the parties who wait too long risk settling at a point in the continuum of the life of the dispute when the relationship can no longer be salvaged.

Many companies and their lawyers recognize these principles and use a form of three-tiered dispute resolution provision in their franchise contract to create discipline and help identify disputes suitable for negotiated settlements or ADR.² Such a clause

² Some law departments may utilize a suitability screen to guide lawyers and clients through a proper analysis of the conditions to consider when determining whether a situation is appropriate for mediation or

might require authorized representatives of the parties to negotiate in good faith when a disagreement arises under the franchise contract. If the issue is sufficiently important and the parties are unable to negotiate a resolution, the contract might then require the parties to refer the matter to mediation before an organization such as the CPR Institute for Dispute Resolution.³ If the parties mediate but reach impasse, either side would be at liberty to litigate (or arbitrate) the resolution of the dispute. That parties agree to a tiered dispute provision does not necessarily foreclose them from immediately filing litigation, particularly if exigent circumstances require an injunction to preserve the status quo or to enjoin irreparably injurious conduct. If one party races into court merely to control the venue in a matter where the subject is a simple contract dispute, a court faced with the issue may enforce contractual commitments to mediate.

While it is true that mediation differs from arbitration in the sense that mediation does not lead to a non-consensual resolution of a dispute, negotiations conducted under the guidance of experienced, trained neutrals often lead to consensual resolutions that cannot be achieved by the parties alone. In recognition of the value of non-binding forms of alternative dispute resolution, such as mediation, to resolve conflict in ways that eliminate the burdens and expenses of litigation on both the parties and the judicial system, courts have indeed enforced agreements to engage in various forms of non-binding ADR. An example of this line of thought can be found in *AMF Inc. v. Brunswick Corp.*, 621 F. Supp. 456 (S.D.N.Y. 1985). There, the court rendered a decision to enforce

other dispute resolution practices. Discussion of the various dispute suitability screen questions and related analysis is beyond the scope of this article.

³ CPR has a successful program called the National Franchise Mediation Program, which consists of a group of franchise companies, franchisees and franchise associations whose mission involves promoting the use of negotiation and mediation to resolve franchise disputes. The matters referred to mediation through the NFMP have a high success rate, with more than 85% of disputes referred to mediation ending in settlement.

an agreement to submit to a form of alternative dispute resolution that would yield nothing more than a non-binding, advisory opinion. In reaching that conclusion, the court made the following observation:

General public policy favors support of alternatives to litigation when these alternatives serve the interests of the parties and of judicial administration. Here [the parties] agreed . . . that a special ADR mechanism would serve them better than litigation. Such decisions are encouraged by no less an observer than the Chief Justice of the United States. In his words, ADR devices are often superior to litigation “in terms of cost, time, and human wear and tear . . .”

Id. at 462 (citations omitted).

Even if a court would not entertain a motion to compel mediation, the very pronouncement in a binding contract is an important pledge on the part of the franchisor and franchisee as to how they want to resolve their disputes.

POST LITIGATION ADR APPROACHES

When informal negotiation and mediation are unsuccessful, the parties have not necessarily wasted their efforts. Each side will have learned more about the strengths and weaknesses of their respective position on the problem. If litigation seemingly is the only alternative, it may be that one or both parties are more focused on rights than on business interests. If one side, for example, believes it is necessary to prove that their view of the dispute is the factually and legally correct view, litigation, not mediation, is the correct forum. Only litigation can result in a legally binding adjudication of the parties' rights. Mediation, on the other hand, by definition requires compromise and is focused on the respective mutual interests of the parties and enables them to fashion an outcome to which they choose to be bound. Of course, if the parties are unable to resolve a matter

through mediation, the parties always retain the right to have a judge, jury or arbitrator decide how the disagreement will be concluded. Placing resolution of the dispute in the hands of the judicial system will not end the push for early, cost-effective resolution of disputes. In most jurisdictions, litigants will find themselves directed to engage in some form of alternative dispute resolution before they get their “day in court.”

The adversary system recognizes what more and more franchisors appreciate -- alternative dispute resolution methods give litigants a fair chance conserve resources and save business relationships. Franchise lawyers should ensure that their clients understand courts are not particularly well suited to resolve routine business disputes. After all, no one knows the nature of a franchise relationship better than the parties themselves.

Non-binding, court annexed alternative dispute resolution programs are prevalent in the state and federal court systems on all levels, including the mediation programs currently employed by the federal courts of appeals.⁴ In the decade following the enactment of the Civil Justice Reform Act of 1990,⁵ most federal district courts around the country have adopted one of several approaches to ADR, impelled largely by over crowded dockets and limited judicial resources. The pervasiveness of these court sponsored settlement programs has had a dramatic affect on the practice of law in the courts with a concomitant influence on the way franchise lawyers advise their clients.

Practitioners should appreciate that the ADR flavor varies from jurisdiction to jurisdiction, even within the federal system. For example, in California each of the three main districts has a considerably different approach to alternative dispute resolution. In the Southern District, local federal rules require early neutral evaluations (“ENE”) under

⁴ A comprehensive discussion of the various state and federal court-annexed ADR programs is beyond the scope of this paper.

the supervision of magistrate judges. This ENE program brings litigants into chambers within weeks after responsive pleadings are filed. Failure to appear with clients in attendance will result in sanctions. The judges employ a quasi-mediation format, using joint sessions and confidential caucuses, but use evaluative, not facilitative techniques in reviewing the case with the clients and lawyers. The magistrate judges will typically only block out two hours and at most a half day for the ENE conference, and will continue to schedule follow up conferences until convinced the parties reached impasse. From a litigant's perspective, the ENE experience may feel more like arm twisting than facilitative, business-oriented mediation.

In the U.S. District Court for the Northern District of California, which also has a court annexed ADR program, the magistrate judges play a more traditional mediator role. There, the judges use a facilitative approach and will block out a full day with the parties. One magistrate judge from this district had worked into the evening to help resolve a three-way franchise dispute. Two of the parties were able to negotiate and reach terms on a new franchise relationship, while the other two accomplished a work out of a landlord-tenant situation, enabling the tenant to exercise a right to purchase at the conclusion of the lease and franchise the facility. Finally, the Central District, like other districts around the country, does not have a court-annexed program per se but will hold a settlement conference or support the parties if they wish to use private mediation to attempt to resolve their dispute.

Lawyers who represent franchise corporations should use the momentum of the pro-ADR trend in the administration of the courts and recognize what ultimately is better for business -- a dispute resolution focus that encourages mediation before litigation to

⁵ [add cite]

help grow the business and improve on the bottom line. Legal departments are cost centers under constant pressure to reduce or contain litigation expenses, and should view ADR as a way to advance the important corporate goals of reducing costs, retaining business critical relationships and improving the long-term performance of the enterprise. In short, proactive measures to manage conflicts will reduce outside legal costs and preserve relationships by resolving business problems in a customer-oriented manner.

Corporate franchise clients can achieve these goals through the adoption of an ADR policy. Leaving the fate of the franchise relationship in the hands of a judge, jury or arbitrator will not sustain this fragile structure. In certain instances, such as when a terminated franchise does not desist using trademarks without a license or there is a need for a judicial precedent, a franchisor undoubtedly will need to fight the battle. The franchisor will lose the commercial war in the marketplace if it lacks sensitivity to the recognize that certain battles are not worth fighting and neglects to create a sensible dispute resolution process for resolving conflict in a manner that builds good will and saves relationships. With increased awareness of the insidious waste that can flow from poor conflict management, franchisors should take the bold step of making an express policy and commitment to alternative dispute resolution.