Dispute Management, Negotiation, and Settlement Techniques in Franchising

by

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CHAPTER 54

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I. Techniques in Dispute Avoidance

A. Current Legal Atmosphere

1. Background

A franchise organization inherently contains the seeds of friction and dispute — issues of growth; economic opportunity; franchise relationship life cycles; changing competitive, technological, and regulatory environments; personality factors; franchisor blunders (commercial or legal); and inherent tensions when one business organization retains discretionary authority over important business management decisions of another. All of these factors contribute to a significant number of opportunities for disputes to arise between a franchisor and a franchisee, and, in some cases, between franchisees within the same organization. For a franchisor or its attorney to structure a franchise contract and to launch a franchise program on the assumption that disputes can be avoided altogether is at best naive, and at worst possibly disastrous. The near certainty of disputes must be taken into account in planning and managing a franchise system. The challenge to franchisors and their counsel is to recognize the inevitability of conflict, identify the most likely sources of conflict within a particular industry or system, and build in procedures to dissipate friction and resolve problems before they erupt into litigation, breakaway franchisees, or, what is sometimes worst of all, organized dissension within the system.

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2. Where Have All the Class Actions Gone?

As franchising matured through the late 1960s and 1970s, disputes between franchisors and franchisees frequently were addressed in class actions under Rule 23 of the Federal (or corresponding state) Rules of Civil Procedure. The class action was regarded by many franchisee/plaintiff's attorneys as the most powerful and appropriate weapon to bring to bear to resolve business, policy, or philosophical disputes between franchisees and the franchisor. While class actions generated enormous amounts of legal activity of interest and benefit to the litigation counsel involved, they were only occasionally helpful in achieving beneficial results for franchisees. In some cases, the class action actually did more harm to the system and the interests of other franchisee-investors than it provided benefit to the lead plaintiff. In other cases, however, class action settlements by means of a stipulated and provisional settlement class provided a "Magna Carta" of basic rules or concepts that have peacefully and effectively guided subsequent growth, and fostered constructive relationships, within a franchise system to the mutual benefit of all participants.

During the last few years, by contrast, franchisee class actions have almost been unheard of. While it is difficult to draw meaningful, broad conclusions from the absence of reported class actions, it is reasonable to speculate that the increasing sophistication of the franchise bar, including specifically franchisee-oriented lawyers, has fostered an awareness that franchisee interests can be pursued more effectively through other means. The absence probably also reflects growing sophistication on the part of franchisors in managing dispute resolution procedures within their systems which reduce the likelihood of "real" class actions (as distinguished from purported class actions brought by individual or dissident franchisees in which the majority of franchisees in the system have little or no interest). The absence probably also reflects resolution, by legislation in some cases and by "industry consensus" in other cases, of structural and philosophical issues relating to franchise systems that had generated some of the class actions in the 1960s and 1970s. An example would be the almost universal availability in business format franchises today of a clear, if conditioned, right of the franchisee to transfer the franchise to a qualified successor — something not universally present in the 1960s.

The availability of class action procedures has also been reduced by the increasing use of mandatory arbitration clauses in franchise agreements. "Class" procedures are not generally available in arbitration.

Stipulated settlement classes, structured on an "opt-out" basis, have proven enormously useful in several franchise systems as a means to impose, with *res judicata* effect, a negotiated settlement agreement containing contractual reforms on all franchisees in the system (excepting opt-outs). A franchisor has no better means of imposing a near-unanimous, simultaneous contract revision on large numbers (if not all) of its franchisees.

Finally, it must be acknowledged that the holding of the Third Circuit in *Ungar v. Dunkin Donuts, Inc.*, 531 F.2d 1211 (3d Cir. 1976), that in a class action alleging "tying" violations of the Sherman Act, proof of coercion must be shown individually for each class member, had a notably chilling if not lethal effect on class actions in this once-ubiquitous source of franchise litigation. *Ungar* by itself, however, cannot explain the recent dearth of franchisee class actions in the myriad other areas of potential dispute between franchisor and franchisee.

3. FTC Activity

During the 1960s, as business format franchising expanded throughout the U.S. economy, a number of franchisor practices came under increasing governmental scrutiny, primarily by the Federal Trade Commission (FTC). The 1960s were a time of judicial activism, in which governmental intervention in private sector business activities seems to have been much more common than during the last decade. The decade of the 1960s was a time of expansionist interpretation of federal antitrust laws and was characterized by a politically active, and intervention-oriented, FTC. The rule-making proceeding that led to the FTC Rule on Franchising (16 C.F.R. Part 436) was commenced at the end of this period.

Franchising in the 1960s was still a relatively young phenomenon which had not evolved highly developed, well-understood, and commonly observed sets of legal rules or, in some areas, industry norms, to guide franchisors in structuring and administering their franchise systems. Little guidance was available to enable franchisees to understand what sorts of franchise requirements were "fair" and which were not. This created a ripe opportunity for legal contests when franchisee investments were jeopardized by overbearing franchisor conduct or requirements.

During this period, the FTC brought a number of lawsuits under various statutes challenging restrictive practices being pursued by many franchisors, primarily in the area of product supply, involving tying issues and other legal principles. Litigation during this period, for example, established the principle that a franchisor could not compel franchisees to purchase from it or its designee most components of the supplies for the franchised business, except where the franchisor could show that no less burdensome means were reasonably available to assure justifiable business objectives going to the heart of the franchise system. *Susser v. Carvel,* 332 F.2d 505 (2d Cir. 1966); *Carpa, Inc. v. Ward Foods, Inc.*, 536 F.2d. 39 (5th Cir. 1976). FTC litigation during this period also established the illegality of undisclosed kickbacks from designated vendors. *FTC v. Texaco, Inc.*, 393 U.S. 223 (1968).

The ascendance of "conservative" (or "Chicago School") judicial and economic theories during the 1980s has resulted in an FTC that is far less interventionist-oriented than in previous periods and one whose perception of the philosophical objectives of the antitrust laws differs materially from what prevailed in prior decades. Today's FTC is far more likely to allow investors and the marketplace to decide which franchise practices are "fair," intervening only in rare cases of widespread fraud or nondisclosure, or under antitrust principles only in cases where egregious anticompetitive behavior is present.

One consequence of a passive FTC is that private parties now bear the entire burden of pursuing whatever innovation may occur in theories of unfair business practices, and the meaning of the antitrust laws as they affect franchise relationships.

Exactly the same trends in thinking about the interrelationship of law and economics, combined with a generally more conservative judiciary, had also resulted in the virtual elimination of federal antitrust law as a meaningful source of judicial relief for franchisees offended by various types of restrictions built into franchise programs. Even the area of tying, once the most feared antitrust threat to most business format franchisors, was almost totally eviscerated for most franchisors by the Supreme Court in *Jefferson Parish Hospital v. Hyde,* 104 S. Ct. 1551 (1984). A currently unresolved but major question in antitrust law affecting franchising is the implications of *Eastman Kodak Co. v. Image Technical Services,* 112 S. Ct. 2072 (1992), on tying doctrine. *Kodak* can be read to revive the applicability of pre-*Jefferson Parish* tying doctrine to many business format franchise systems.

4. Franchise Relationship Legislation

Franchise relationship legislation now on the books of nineteen U.S. jurisdictions (in one form or another) has had three principal impacts. In some states where the law spells out a list of prohibited and/or mandatory practices with specificity and some clarity (*e.g.*, Indiana, I.C. Title 23, Art. 2, Ch. 2.7, §§ 1-7; Minnesota, M.S.A. §§ 80C.13-.14; and California, Bus. and Prof. Code § 20000 *et seq.*), there has been a relatively small volume of litigation, probably because most players understand and follow the rules, or their transgression is sufficiently apparent to induce quick settlements.

In others, where the law is vague and inflexible but clearly one-sided, most notably Wisconsin, Wis. Stat. Ch. 135 (the "Fair Dealership Act"), there has been a comparative torrent of litigation. Perhaps the most surprising impact of any of these laws has been their reach to unsuspecting, "inadvertent" franchisors — companies that established dealerships or distributorships and then "discovered" the existence of the law, or the applicability of a "franchise" law to the "dealership" — in nonclass actions commenced when the dealership business failed, the dealer suffered "buyer's remorse," the producer sought to terminate the relationship, or the dealer tried to break away.

B. Advising Franchisors on Avoiding Serious Disputes

1. The Importance of Procedure

Franchisors have an opportunity to build into their franchise programs, legal documents, operational procedures, and various mechanisms by which inevitable friction and occasional overt disputes can be dealt with constructively and at an early enough stage to avoid serious disruption and litigation in most, if not all, cases. This section outlines a number of those ideas.

2. Franchisee Advisory Councils

Clearly one of the most effective mechanisms for handling inevitable franchisor/franchisee disputes is the use of representative franchisee advisory councils. Such councils provide two indispensable functions: (1) a forum in which policy issues or individual grievances can be aired, in many cases to resolution; and (2) an indispensable source of upward information flow from franchisee to franchisor management.

A franchisor legally must retain the ultimate authority to make decisions concerning standards as to the nature and quality of products or services offered by franchisees under the licensed trademarks in order to satisfy the Federal Trademark Act (the Lanham Act) (15 U.S.C.A. § 1051 *et seq.*). A franchisor also must retain the exclusive discretion to determine when and how to seek remedies against individual franchisees for breach of those standards or other breaches of contract. It does not follow, however, that the franchisor must necessarily act in either area in a vacuum.

To put the matter somewhat more prosaically, while the franchisor reserves the sole ability to make final decisions about the content and enforcement of system standards, policies, and initiatives, a franchisor would be foolish to implement requirements in any of those areas without ascertaining the likelihood that franchisees would willingly adopt or acquiesce in the franchisor's program. A franchisee advisory council can be an excellent means of establishing in advance whether or not a proposed change in a system will be welcomed or resisted by franchisees, or indeed if it might be improved by consultation with franchisees. Few, if any, franchisors can genuinely and safely conclude that they indeed know it all and have no need to seek advice and guidance on major or minor systems decisions from their franchisee community.

To be effective for the franchisor, and credible to other affected franchisees who are not directly and personally involved in the deliberations of the council, the council must be truly representative of franchisee interests. While it might be perfectly appropriate for a franchisor when establishing, or encouraging the establishment of, a franchisee advisory council to appoint initial members (analogous to the "incorporators") of the organization, succession to membership on the council should be left to the discretion of franchisees on an elective basis. Elections should be structured in such a way that the representation on the council will be as broad as possible within the system.

To the extent that specialized expertise is required or useful, councils can be subdivided into committees, or organized separately on different issues (such as separate advisory councils on advertising issues, and on procurement). Councils can be broken out geographically. The form of organization of the council should be an unincorporated advisory committee, serving at the pleasure of the franchisor.

An advisory council is not inconsistent with an autonomous, separately constituted franchisee association whose organization, structure, functions, and financing can be left wholly to franchisees. This will leave in the hands of franchisees critical decisions concerning the taxability of their association, provision for indemnification of its members, liability allocations, and other basic structural issues best left to the constituents of the association.

Some franchise agreements have gone so far (wisely in our opinion) as to mandate franchisee membership or participation in a franchisee advisory organization and, in some cases, even to require membership in an independent franchisee association which performs functions going far beyond those of an advisory council.

When viewed as a sounding board and discussion forum, an advisory council as an intermediary need not have decision-making authority, and it need not necessarily be viewed as intervening or interfering in the direct contractual relationship between a franchisor and its franchisees. Because an advisory council properly should be viewed as not having decision-making authority that is contractually binding on either the franchisor, the council, or its constituent franchisees, the existence of the advisory council and the franchisor's active and regular interaction with the council need not and should not be viewed as establishing a mechanism for "collective bargaining" on franchise contractual, legal, or commercial issues. We also see no reason for a franchisor refusing recognition of and direct dealing with employees or professional staff of a council or franchisee association.

Franchisee advisory councils work best when they are separated from substantive business operations such as those encountered in a separate purchasing cooperative or advertising cooperative, by whomever controlled or funded.

3. Collective Bargaining

Part 2 of this section alluded to franchisors fear of "collective bargaining" with franchisees. Nothing in the law currently obligates franchisors to bargain collectively with franchisees. Even § 202 of the final Uniform Franchise and Business Opportunities Act, which would guarantee franchisees the right to form independent associations, contains a comment specifically disclaiming the creation of a duty to bargain. Similarly, common law principles relating to the formation and enforcement of contracts, such as doctrines of unconscionability, estoppel, fraud, mistake, etc., do not imply a duty on the part of the franchisor to bargain individually or collectively with franchisees in connection with the formation, revision, or renewal of franchise or ancillary agreements.

Virginia gives new franchisees a thirty-day opportunity to rescind the franchise agreement where the franchisee was not afforded the opportunity to bargain on any of the terms of the franchise. Va. Code § 13.1-565(b). But this law relates to the offer and sale of franchises, not to their subsequent administration, and does not call for collective bargaining in any case.

The common law duty of good faith (*Restatement (Second) of Contracts*, § 205) imposes a duty of honesty in fact and fair dealing on all parties to a commercial contract (surely including a business format franchise). But by imposing the duty on the parties to the contract, the duty of good faith focuses on the particular contractual (usually bilateral) relationship and does not contemplate multiparty relations or bargaining. Also, the section does not apply to the formation (negotiation or "sale") of a franchise contract, but to its performance and enforcement. Nothing in the case law cited in the commentary to § 205 relates to a duty to bargain, providing instead only that a party may not lie or withhold material information, or act in a way that violates reasonable commercial standards of fair dealing applicable in the trade, during the course of the ongoing commercial dealings between the parties.

Because the franchisor has individual contracts with each of its franchisees, its discussion with representative groups of franchisees under a setting clearly identified as "advisory" cannot be viewed as creating any obligation on the part of the franchisor to deal collectively with franchisees as to their contractual relationships and obligations. Even state antidiscrimination laws (*e.g.*, Washington Franchise Investment Protection Act § 19.100.180; Minnesota Franchise Regulations § 2860.440.B) allow for exceptions to what is otherwise a statutory policy of monolithic uniformity of treatment where reasonable business justifications can be advanced for drawing distinctions between otherwise similarly situated franchisees. This permits variations in franchise terms to allow for local market circumstances, such as special assistance programs for troubled, start-up, or minority franchisees. The very concept of allowing for such discretionary, but commercially reasonable, differentiation among franchisees is antithetical to the implication of a collective bargaining obligation.

The absence of an obligation to bargain collectively does not mean that in particular circumstances it might not be prudent to do so. There are times when the need to resolve disputes, or to effectuate broad changes, within a franchise system suggests that a collective approach can be of enormous value to a franchisor. One mechanism for effectuating such solutions is stipulation to a settlement class to resolve purported class action litigation. Still another is to enter into a contractual undertaking between the franchisor and an association of franchisees which purports to be broadly representative. If the contract is intended to alter, waive, limit, or condition the franchise agreement itself, implementation of the contract can be conditioned upon affirmative concurrence by a designated, but high, proportion of franchisees in the system.

4. R.E.S.P.E.C.T.

Another idea at the top of the list of means of minimizing and dissipating (if not avoiding altogether) disputes with franchisees is the simple concept of respect. Franchisors who are overbearing, omniscient, unduly aggressive, overly self-interested or who fail to respect aspirations of franchisees to succeed in their businesses and indeed to grow and expand as their businesses flourish, and franchisors who fail by act or neglect to acknowledge and respect the investment and commitments of their franchisees, are inviting dissension and adversity. We submit that it is not healthy for any party to a franchise relationship to allow that relationship to assume a "parent-child" stature, with the franchisor purporting to assume the role of the stern but loving disciplinary parent. At the same time, a franchisor must understand that a franchise system necessarily involves a multiplicity of interests, not just its own immediate economic best interest. This is one area in which franchise organizations differ materially from other forms of corporate business enterprise, in which advancement of the organization's own best economic interest is of paramount, if not exclusive, importance.

Franchise relationships are not partnerships in any meaningful legal sense of the word, but neither are they arm's-length transactions or relationships between otherwise disinterested parties looking out solely for their own best interest. Franchises may be best thought of as business collaborations (not quite rising to the level of joint ventures), implying that the franchisor at least must take into account and consider the investment commitments of the franchisee and the need of the franchisee for a reasonable opportunity to earn a return on that investment.

Two simple examples will illustrate this concept. It would be more than reasonable for a franchise agreement to obligate a franchisee to make periodic reinvestment in the premises of the franchise business to maintain its physical integrity, safety, attractiveness, and even conformity to evolving standards of system "image." It would be inappropriate, however, and a sure source of dispute and dissension, for a franchisor to exercise those principles in ways that force franchisees to make significant reinvestment in physical facilities at close intervals, or in radically divergent "looks" from one remodeling to the next, or pursuant to vague, subjective, and shifting standards.

Another example is a franchisor that imposes restrictions or conditions on a franchisee's ability to sell its business to a new franchisee, in ways that go beyond the legitimate, clear, and basic needs of the franchisor in assuring the integrity of the franchised business and the reasonable qualifications of the proposed successor franchisee. Conditions or qualifications to a right of transfer that go beyond those minimal standards have a material and deleterious effect on the recoverable value of the franchisee's investment in the business and do not create an environment in which franchisees are likely to have the incentive to make investments of time, effort, or dollars in the success of their own franchised business, and derivatively in the franchise system as a whole.

5. Record Keeping

Another dispute avoidance technique may be expressed simply as making sure that all the players know all the rules of the game, before the game starts, and that the score-keeping of the game is done objectively and fairly. Franchisees must be taught through formal training programs, system meetings, operations manuals, and other techniques that are consistently documented exactly what is expected of them so that the performance obligations against which they will be measured are clearly perceived. This requires objective, written, and periodically reinforced standards. It does not militate against periodic change in a system, provided that reasonable advance notice and an opportunity to participate in the decision-making process is given.

Franchisees should be encouraged to keep accurate and contemporaneous records of the performance of their business, including, but in no sense limited to, the financial records customarily required in business format franchises.

Franchisors likewise should keep comprehensive written records on franchisees' performance of their contractual obligations. Such records are of obvious and indispensable value to a franchisor in rare cases where the termination remedy becomes appropriate, but it is even more important to create, maintain, and share such records with the franchisee for didactic purposes. The ultimate objective of a franchisor's inspection, monitoring, and enforcement procedures is, or should be, to assist and encourage franchisees to meet system standards, perform well, and succeed, rather than to lay in record to support termination of a nonperforming operator.

6. Morale-Building Techniques

The holdings of the *Burger Chef* cases, *Vaughn v. General Foods Corp.*, 797 F.2d 1403 (7th Cir. 1986), and *O'Neal v. Burger Chef Systems, Inc.*, Bus. Fran. Guide (CCH) ¶ 9251 (6th Cir. 1988), make clear that franchisors' ordinary, systematic, and emphatic encouragement of franchisees to continue to invest in their businesses and perform their franchise obligations, even in circumstances where the franchisor is contemplating or has made a decision to dispose of the franchise system, is not fraudulent under state law. A franchisor should incur no legal liability, therefore, but may derive significant benefits from keeping franchisees' morale up on a regular basis by a variety of motivational techniques, exhortations, and salesmanship even in cases where the system as a whole is not performing well.

Leading by doing rather than exhorting is an excellent morale builder. If franchisees see that a franchisor has enough confidence in its product development, procurement, facility enhancement, marketing, or advertising decisions to implement them at the franchisor's own units, rather than to simply impose on franchisees' untested or thinly tested innovations, franchisees are much more likely to follow the franchisor's lead than to resist the change.

Substantive, ongoing franchisee participation in a franchisor's policy-setting activities, as discussed above under franchisee advisory councils, also will have a significant therapeutic effect on maintaining franchisee morale. It is basic human nature to want to be heard and acknowledged, and this is no less true in franchise relationships than it is in personal relationships. Acknowledging the need through regular process in a franchise system does not necessarily imply that either party will always get its way, even in cases where opinion on a given subject may become rather polarized, but it can go a long way toward keeping differences of opinion from escalating into litigation.

Franchisee morale will also be enhanced when franchisees recognize on an ongoing basis that their franchisor has a real interest in their own prosperity and growth. Franchisees are able to repose trust in their franchisor's competence when there is a demonstrated track record of carefully thought out, thoroughly tested innovations in the system to maintain its competitive posture and the value of the franchisees' investment.

C. Specific Ideas in Dispute Avoidance

1. Sending Messages

Many franchisors recognize the value of carefully selecting test cases to "send a message" to a franchise community both as to the franchisor's willingness to resort to appropriate enforcement mechanisms when necessary and to demonstrate that the franchisor is willing and able to take steps necessary to protect the value of its trademarks and the integrity of the system.

When considering action against a franchisee motivated by these considerations, the franchisor would be well-advised to think through all of the ramifications of the message it proposes to send. Too aggressive an enforcement posture, or the absence of a meaningful internal "appellate review" process, may convey the highly undesirable and destabilizing message not that the franchisor is intolerant of substandard operators, but that it is assuming an aggressive, inflexible, and adversarial posture hostile to the general welfare of franchisee members of its distribution system.

Even franchisor conduct in areas unrelated to enforcement issues can "send a message" in ways the franchisor may not intend. Aggressive exploitation of economic growth opportunity within the system to the exclusion of franchisee participation can send franchisees a message that they have no future in the system and might be better advised to seek investment opportunities elsewhere. For a franchisor contemplating forward integration, that course may be desirable. For most franchisors, however, that would not be a desirable outcome.

2. Management Style

Along the lines outlined in the preceding section, franchisors should strike a balance, a "golden mean," between the extremes of police state, *in terrorem* enforcement and administrative style, on the one hand, and on the other, a subservient indifference to franchisee behavior that signals that franchisees can get away with virtually any disparate behavior under the franchisor's flag. Neither extreme creates an environment conducive to the well-being of the chain as a whole, or an environment in which intelligent franchisees will be incentivized to invest and reinvest in the success of their units, or of the system as a whole.

A desirable management style to create a climate conducive to continued franchisee investment and growth of the system will include elements of objectivity, moderately aggressive education and policing, and a mechanism for making exceptions to rules to accommodate local market circumstances and special needs of franchisees.

Internal concepts of due process should be factored into all franchise administrative mechanisms. For example, personality conflicts can and do arise at the field level between field employees and franchisees, and even between higher-level franchisor management and franchisees. Both favoritism and prejudicial bias can creep into franchise systems without the conscious intent of the franchisor's senior management, and provision must be made for internal "appellate review" of decisions made at lower levels of the franchisor's administrative structure.

For the same reasons, it would be wise for franchisors to periodically rotate field and intermediate management personnel precisely to preclude the development of either too cozy relationships or relationships containing the seeds of friction.

It goes without saying that effective franchise administration demands that franchisor administrative personnel in the home office and in the field be thoroughly trained both as to the franchisor's systems and goals and as to the operating environment, investment, and aspirations of franchisees.

In a purely legal sense, franchisor administrative and management techniques must be sufficiently active, continuous, and aggressive to meet the franchisor's legal obligation under the Lanham Act to monitor and police on a regular and effective basis its licensees' use of its trademarks.

3. Franchisor "Malpractice"?

It is not inconceivable that we may see the emergence in the United States of a common law cause of action based upon a franchisor's "duty of competence," of a quasi-contractual nature, perhaps as an extrapolation from the common law duty of good faith, or perhaps as an outcome-oriented response to egregious incompetence by a franchisor. Such an action would amount to a "malpractice" action by a franchisee against a franchisor.

Examples of circumstances in which such an action can be envisioned include: franchisor promises of site selection assistance which proves to consist merely of a "drive-by," curbside appraisal by an untutored real estate representative development official; a decision to roll out an untested or insufficiently tested new "menu" product which subsequently fails in the marketplace despite significant franchisee investment to carry the product; or designation of a mandatory item of equipment which either contains design defects presenting a risk of personal injury to a franchisee's employees or customers, or perhaps that simply does not have sufficient output capability to support foreseeable levels of demand by customers of the franchisee.

The best way to prevent real harm to franchisees and thereby minimize the risk of litigation to recover resulting losses, is to solicit franchisee input during the development of franchisor programs or new products, equipment, or facilities, give due regard to that input, and then act in a conscientious and responsible manner.

A franchisor, in sum, need not become a guarantor of its franchisee's success, but it can successfully avoid many potential disputes by performing competently those duties and programs it undertakes to perform.

4. Communication Strategy

Information flows in any business organization should proceed in both directions, upward and downward. The upward flow of information is almost always more important to the strategic success or failure of the organization than the downward flow. Franchise organizations that fail to take this into account and that do not provide regular, secure, and open channels of communication from, not just to, franchisees are taking an unnecessary risk both in a commercial sense, and in the dispute avoidance sphere. Franchisees should be listened to as much as they are spoken to in order to head off disputes before the franchisee feels constrained to resort to litigation. It is regrettable but true that franchisees sometimes sue primarily to get the franchisor's (or its senior management's) attention or to force the franchisor to be more flexible.

Some means should be provided for individual franchisees to have direct access to the CEO of the franchisor in appropriate, and widely understood, circumstances. Access to the CEO should be provided both in group and private environments.

Information flows "downward" to franchisees should also be systematic, frequent, and wide-ranging. Franchisees, like most business owners, tend to be quite conservative, and frequently react negatively to any proposed change in a franchise system or business operation, however well-tested and potentially beneficial the change may be. Communication upward and downward in a franchise system can go a long way toward cultivation of an environment in which responsive or proactive change can be implemented with the enthusiastic support of most, if not all, system franchisees. This will keep many potential disputes from ever arising.

5. Ombudsman

A well-known, but little used, European technique for cutting through red tape in both municipal and business organizations is the "ombudsman." An ombudsman is an employee of the organization, in this case the franchisor, on the franchisor's payroll who reports to a senior executive office of the franchisor. The ombudsman has the responsibility and *carte blanche* authority to act for and on behalf of individual franchisees with problems that are not being addressed on a timely and effective basis through established, customary business channels within the franchisor's organization. The ombudsman has authority to go directly to any appropriate official within the corporation, including its CEO, to convey information, procure action, and to negotiate disputes. The ombudsman will have a clearly defined, but broad, authority to act to bind the franchisor in resolutions of individual differences with franchisees.

D. Contributing Value over Time

Closely related to the concept of morale building, discussed in § I.B., is the notion of the franchisor contributing value over time to the franchise relationship. In most franchise systems, there is a life cycle during which at some point the franchisee will have a waning appreciation for the contributions of the franchisor to the current success of the franchisee's business. This attitude will invariably call into question in the franchisee's eyes the value of the ongoing consideration received for the franchisee's ongoing payment of system royalties and advertising fees. This attitude builds resentments which will fester unless anticipated and dealt with by means of dispute avoidance and resolution techniques appropriately tailored to the particular industry sector and franchise system, and by providing continuous enhancements to the value of the franchisee's continued participation in the franchise organization.

II. Negotiation Techniques

If a dispute arises, in spite of application of the "atmospheric," structural, and managerial techniques described above, franchisors, franchisees, and their counsel must turn to the business of negotiating a resolution. What techniques are particularly useful in a franchise setting? What steps can be taken informally, what alternate dispute resolution techniques are available, and what other measures can be taken short of going to war?

A. Situation Analysis

In any dispute involving a franchisor and a franchisee, attorneys can assist their clients by providing a dispassionate and careful analysis of the situation. What specific facts gave rise to the problem? How successful has the franchisee been as an operator? Has the franchise owner paid royalties on time? Is the legal documentation of the franchise in order? Was the franchise offering effectively registered when the franchise was sold? If the franchisee is unhappy, what are the factors that have led to the unhappiness? Are other franchisees involved? Does the franchisor perceive a threat to its system? Does the problem reach beyond this particular franchisor/franchisee relationship? How much money is involved and what has been the payment pattern?

Counsel should plan to develop a checklist of questions depending on the type of dispute that has arisen. Carefully evaluate the information you have in your file and make sure it is as complete as possible. The basic documents evidencing the franchise relationship should be in your possession and you should take careful notes in your discussion with your client regarding the situation.

B. Settlement versus Trial

Keep in mind the advantages to your client of settling disputes as opposed to allowing them to ripen into litigation.

1. Early settlement avoids the staggering costs of trial which include not only attorneys' fees but court costs, fees to expert witnesses, time and resources spent attending the trial, and intangible but real expenses of executive time and attention.

2. In a franchise setting, litigation can be corrosive of the entire system. In addition, any litigation comes with its social and psychological costs such as embarrassment and damage to the relationship with the litigating franchisee and other franchisees, as well as the public relations cost to be paid when a company washes its dirty linen in public.

3. The outcome of litigation is uncertain and always difficult to predict, even by old hands in the profession.

4. Litigation is in a time warp all of its own that makes nonsense out of any practical utility in resolving disputes between franchisors and franchisees. The franchisor wants the resolution in weeks; litigation will take years.

5. A negotiated settlement avoids a combative, "winner take all" mentality and allows creative business people to fashion resolutions tailored to the interest of all parties.

6. Whereas litigation (and arbitration) must be disclosed in a franchisor's offering materials, a private settlement of disputes where litigation has not been filed does not have to be disclosed.

For all the advantages of negotiation and settlement, any good lawyer will tell you there are circumstances where there is a presumption against going forward with settlement discussions and that the parties should press forward with litigation. For instance, if a franchisee brings a "suit with no discernable merit" and it appears designed only to trigger disclosure obligations and otherwise harass the franchisor, settlement discussions simply will not make sense. In some circumstances, a franchisor will decide to "send a message to the system." These are some of the most difficult words counsel will have to deal with representing a franchisor. What will the message be? Will the company and its counsel have control over the message that is actually delivered? Is the case a winner? And what will the message be if the company loses? Obviously, if the franchisee's counsel is unwilling to propose any compromise that is acceptable to the franchisor, or the opposing counsel is so obtrusive and obnoxious as to make discussion impossible, settlement discussions will be greatly inhibited. Legal assaults on the integrity of the franchise system, the franchisor's trademarks, the franchisor's ability to collect royalty fees, and other challenges that threaten the fundamental structure of the franchise system generally should not be the subject of compromise by franchisors.

This being said, the great majority of franchisor-franchisee disputes really lend themselves to settlement discussion and negotiation.

C. Franchise Negotiation — The Basics

Negotiating disputes between franchisors and their franchisees quickly makes evident a significant myth of franchising — that the franchisor has the superior bargaining position. Our experience leads us to the opposite conclusion. Franchisees' superiority of bargaining position reflects the basic fact of business life that franchisees are generally more personally involved in the success and failure of their businesses than are franchisors. Also, a franchisee often has more at stake — his or her entire business. The survival instinct takes over if the franchisee's business begins to fail, and that can make for a fearsome negotiator.

Franchisors should recognize that they have everything to gain from settling a dispute and compromising where compromise is reasonable. We recommend to our clients that they take every opportunity to appear just, equitable, and statesmanlike in their dealings with their franchisees. Meet a franchisee more than halfway in resolving franchise disputes. The intangible benefits of goodwill engendered in the system will turn a potentially corrosive franchisee dispute into a positive business experience for the system.

Learn to spot different negotiation styles. The literature on negotiation characterizes a number of different styles and is careful not to prejudge the effectiveness of any style. In a book entitled *Legal Negotiation in Cement*, Gerald R. Williams characterizes effective negotiators as falling into two different categories: "Cooperative Negotiators" and "Competitive Negotiators." Whereas the former are described as friendly, trustworthy, and cooperative, the latter are characterized as dominating, competitive, forceful, tough, arrogant, and uncooperative. This description is misleading to the extent that it describes wimps and tigers and does not characterize what makes both types of negotiating styles effective. Effectiveness of both types of negotiating styles is analytically linked to thorough preparedness, experience, honesty, trustworthiness, and ethical behavior. Both types of negotiators are self-controlled and have an acute talent for reading their opponent's cues. The Williams book also suggests that both types of effective negotiators are also rated as effective trial attorneys. If a negotiator is not an effective trial counsel, an opponent may decide the better strategy is to cease negotiations and take advantage of the weakness of his or her opponent by taking the matter to trial.

There appears to be only one solution: to be taken seriously, lawyers who negotiate legal disputes (as opposed to nonactionable matters) must either develop substantial expertise as trial attorneys or must openly associate themselves (whether by partnership, a referral system, or some other way) with very effective trial counsel. Williams, *supra*.

We have found it most useful to keep in mind some of the basics of negotiation theory in resolving disputes on behalf of our franchisor and franchisee clients. The literature makes it clear that there are one or two guiding principles of negotiation that will apply in virtually all circumstances.

Principle One is simple: keep it objective. That is, in all discussions, try to separate the problem from the people involved. Remove as much as possible the emotional defensiveness and natural paranoia of individuals involved in dispute discussions. Do not be drawn into discussing positions taken by the parties but rather review objectively the interests of the parties involved.

In *Getting to Yes: Negotiating Agreement without Giving In*, authors Fisher and Ury note that negotiating on the merits has three basic elements.

1. Frame each issue as a joint search for objective criteria.

2. Reason and be open to reason as to which standards are most appropriate and how they should be applied.

3. Never yield to pressure, only to principle.

It is the insistence on objective criteria for seeking resolution that leads to effectiveness in negotiation. Suppose a franchisee has contacted your client stating that the franchisor has failed to live up to the assistance promised in the franchise agreement, that the franchisee wants to terminate the contract, and that damages are due in the amount of $1 million. Your client advises you that it would just as soon have this "troublemaker" out of the system and asks you to assist in fashioning a mutual termination and settlement. Your checklist should include studying the financial relationship of these two parties, the franchisee's performance under the franchise agreement, royalty payment history, and, in particular, information regarding how that franchisee's business has performed. In negotiation discussions with the franchisee or opposing counsel, the first point of discussion should be an inquiry of the franchisee as to how he arrived at the $1 million of damages owing to him. How are they measured? Do they take into account his revenues since beginning the franchised business? What are the merits of the relative bargaining positions of the franchisor and franchisee? And more importantly, what are their relative interests?

The role of legal counsel in negotiation of disputes should be carefully considered. How soon should a franchisor bring its legal counsel into the picture? Is the mere fact that the franchisee has retained counsel enough to require a franchisor to bring you into the picture? This judgment call can be made only in consultation with the client regarding the tenor of discussions and whether the client has a sense of progressing toward resolution.

Without question, the appearance of lawyers on the scene can often escalate a dispute situation. It is our general approach that lawyers not be brought into the picture and their role made visible to the other side unless and until the client feels it is no longer progressing toward resolution. We are also uncomfortable in having our clients negotiate dispute resolution with attorneys representing their franchisees. We generally recommend that businesspeople communicate with businesspeople only. There are obvious exceptions to this rule and many mature and self-confident franchisors can easily handle negotiating disputes with franchisee counsel. We do recommend, however, that the franchisor keep its legal counsel copied on all correspondence and updated on discussions in the event matters appear to be getting out of hand.

III. Ideas in Negotiating a Franchise Dispute

A. The Settlement Partner

We have had success in our franchise dispute resolution work at designating an attorney within the law firm whose primary objective is fashioning a workable settlement of a dispute. The "settlement partner" is more than an institutionalized good guy/bad guy routine. It allows the lawyers involved to concentrate efforts to settle matters and does not confuse the role played by litigation counsel in prosecuting the client's case. The settlement attorney should be given free rein to explore creative solutions to a given dispute and must certainly coordinate efforts with those of litigation counsel.

B. Litigation Disclosure — The Franchisee Hammer

One of the tools available to franchisee counsel in fashioning dispute resolution is the threat to the franchisor that if a lawsuit is filed, it may require disclosure in the company's offering materials. Item III of the Uniform Franchise Offering Circular requires disclosure of any " ... material civil action ... pending against [the franchisor or any person identified in item II] alleging a violation of any franchise law, fraud, embezzlement, fraudulent conversion, restraint of trade, unfair or deceptive practices, misappropriation of property or comparable allegations."

This offers a negotiating advantage to the franchisee lawyer that in our experience is only dimly understood. Many lawyers, by professional training or practice style, will file a lawsuit and ask questions later. In an important sense, this effectively squanders a negotiating advantage; the franchisor will immediately feel it has paid the price of disclosing pending litigation and will be seriously disinclined to pursue a negotiated resolution. Franchisee counsel must be aware of this bargaining advantage and should not relinquish it without careful consideration of the consequences. One countervailing consideration, if the franchise agreement does not have a binding mandatory venue clause, is to file, but not serve, a complaint to preserve venue in a court of the plaintiff's choosing.

C. Techniques for Handling the Problem of Royalty Delinquency

One of the most frequent complaints of franchisors is delinquent payments of royalties by franchisees. In our experience, there is no earlier signal of business distress or fertile ground for disputes to arise. Franchisors should consider the biweekly or weekly payment of royalties so that a problem can be spotted before it gets too large for the franchisee's business to handle. Some franchisors maintain a "retainer" account that allows the franchisor to draw on funds in the event the franchisee becomes delinquent in payments. One attorney has recommended that franchisors secure a "standby letter of credit" that can be exercised by a franchisor in the event of royalty payment default. Personal guarantees by franchisees of franchise agreement and lease obligations should be considered, and may be as informal as a comfort letter.

Once a dispute has occurred, counsel may be most helpful in fashioning a creative and balanced workout plan so that the franchised business can continue.

IV. Conclusion

Understanding formal alternative dispute resolution techniques is vital to the franchise practitioner. However, it has been our experience that more frequently franchise counsel are called upon to apply basic negotiation techniques. The reasons for avoiding litigation apply to all business but have particular application to franchisors and franchisees. We are confident that applying the techniques and attitudes described in these materials will allow practitioners to serve more effectively their franchisor and franchisee clients.