FRANCHISE AGREEMENTS: A POTPOURI OF POTHOLES TO NAVIGATE
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Arbitration – Things Aren't Always What They Seem

Many states, including California, have laws that void any franchise agreement provision establishing venue for litigation outside the franchisee's state. To circumvent those laws, a number of franchisors have substituted an arbitration provision (which is not considered litigation) specifying that any dispute shall be arbitrated in the home state of the franchisor. Further, regardless of the venue location, the franchise agreement usually requires that the law of the franchisor's home state will apply.

Whenever negotiating a contract, remember that in the absence of a law specifically prohibiting some aspect of an agreement, the parties can always agree to whatever they wish. This default tenet in the law often results in courts enforcing arbitration or choice of law provisions like those described above.

In commercial transactions (as opposed to consumer transactions) the law presumes that the parties are of equal bargaining power and they have the freedom to contract to whatever they wish so long as their agreement is not illegal. For all you franchisees reading this article I am sure you are thinking, "Equal? You must be drinking!"

In California, recent court decisions have begun to recognize the inherent unequal bargaining power between a franchisor and a franchisee. To level the playing field, some courts have held that certain provisions may be unconscionable and thus unenforceable. To do so, the courts must find that the contract is one of adhesion. This basically means that the franchisee accepts the contract on a mostly take it or leave it basis, without any opportunity for meaningful negotiation regarding the terms of the agreement. The only real choice for the franchisee is to choose not to enter into the agreement at all – not usually a desirable alternative.

By forcing a franchisee to travel far to resolve a dispute, the franchisee is often at a substantial disadvantage. Almost invariably, the franchisee's financial war chest for such disputes is substantially less than the franchisor's. Travel expenses for both the parties and witnesses will be greater. This can be a significant factor in negotiating an equitable settlement, or certainly in achieving a cost effective victory.

Of at least equal if not greater importance than the expenses is that these arbitration provisions may include language that substantively affects the franchisee's ability to conduct effective and essential discovery. Such arbitration provisions often state the parties' agreement to minimizing discovery in the hopes of reaching a fast and less costly process. For the franchisee this can be very detrimental to getting the information needed to prove its claims. Usually, we recommend that the subpoena power of a court is the franchisee's best assurance of being able to compel the discovery needed to prove its claims.

Franchisees may be able to obtain a court ruling invalidating an arbitration provision. How the franchisee does that is fairly technical in terms of the legal process and requires counsel who understands both the substantive and procedural issues. Even then the desired result is not guaranteed.

Of course, when selecting a franchisor, franchisees do not expect to end up in a dispute with the franchisor. Certainly, it is more than a remote possibility and these types of provisions need to be considered so that if you decide to proceed, you fully understand the risks.

Guarantees – The Law May Offer Some Protection But Only If You Ready Yourself Properly

Even if you own your hotel in an entity, franchisors typically seek to have the principals sign the franchise agreement in their individual capacities. Whenever possible try to avoid such a result.

Assuming you are working with competent counsel, you have probably been advised that the title to your hotel asset should be in the name of an entity ("Hotel Entity"), either a limited liability company, limited partnership, or a Subchapter "S" Corporation . By doing so, you legitimately insulate your personal assets from creditor claims.

If your equity ownership interest in the Hotel Entity is owned by a trust or another entity, then you, in your individual capacity, should not be a party to the franchise agreement. Especially if there are other beneficiaries or owners of your trust or other entity, you cannot control what happens with the Hotel Entity and so you should not be accountable for the day to day obligations provided for in the franchise agreement.

Franchisors should be willing, in these situations, to accept a personal guaranty for the financial obligations required by the franchise agreement. The extent and enforceability of a person's obligations under a guaranty will be determined by the state law governing the franchise agreement. The different states vary considerably on how guarantees can be enforced. In California, the law affords a modicum of protection in the procedural steps required to enforce such guarantees. While counsel can in no way ensure that California law will govern, there are techniques counsel can employ to increase the probability that California law will be applied to California disputes. Be sure to discuss this with counsel if a dispute does arise.

Under certain guaranty provisions, California law may require the franchisor to proceed with a lawsuit thru judgment against the franchisee, before the franchisor can pursue the guarantors. Typically, lawsuits settle before trial or judgment. The corporate entity, assuming it has adequate assets, will be able to resolve the dispute with the franchisor without the need for guarantors being involved. By being a guarantor to the franchise agreement rather than a party to the franchise agreement, the principals of the Hotel Entity can realize a degree of separation and insulation between the franchisor and themselves. The franchisee's legal counsel must be sufficiently experienced in order to understand and effect what is needed to achieve the desired result.

Normally, cases settle before any judgment and the corporate entity, assuming it has adequate assets, will be able to resolve the dispute with the franchisor without the need for principals being involved. By being a guarantor to the franchise agreement rather than a party to the franchise agreement, the principals involved in hotel ownership can help to create separation between the franchisor and the principals.

Conclusion

Protecting your interests as a franchisee requires an in depth understanding of the technical aspects of the franchise relationship. Educate yourselves, engage competent counsel and consultants, and most importantly, be assertive, firm and reasonable … always working to negotiate an agreement that works for you, not just the franchisor.

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