

The corporate offence applies to bribes paid by persons 'performing services for or on behalf' of the franchisor and in connection with the franchisor's business. The Act stipulates that the 'person performing services' for the commercial organisation may be an employee, agent or subsidiary. The question of whether a franchisee falls within the ambit of the clause is not specifically addressed and will be determined by their actual activities rather than their status as a franchisee. Consequently, the position with regard to franchisees will be considered on a case-by-case basis.

During passage through parliament concerns were raised that the draft Bill risked creating automatic liability for subsidiaries, joint ventures and syndicates, notwithstanding the lack of control over the activities of these entities. The same concerns exist in respect of franchisees. Several amendments were proposed which would clarify the relationship or level of control that a parent would have with its subsidiary before liability could be imposed. However, this was not pursued. Instead, the government has agreed that general guidance will be issued before the Act comes into effect. It is unlikely, however, that such guidance will specifically refer to franchisees. This is something about which the BFA might usefully lobby the UK Ministry of Justice.

The immediate lack of a clear answer in relation to this crucial issue, especially given the strict liability nature of the offence, will be frustrating to franchisors who suspect potentially corrupt behaviour among its franchisees over which they have little or no control.

### **What should franchisors do?**

Franchisors need clarity how they can implement an anti-corruption system which will satisfy the proposed 'adequate procedures' defence on a probative burden on proof.

Franchisors operating in sectors or entering new geographical markets which are susceptible to corruption can only hope that the official guidance does include franchising. Without such guidance, many UK franchisors will face uncertainty in respect of what they should be doing, in particular in relation to their franchisees, and how best to implement 'adequate procedures' designed to prevent bribery being committed on their behalf.

Now that the Act has received royal assent and the corporate offence is likely to come into force during 2010 it is clear that franchisors will have to be proactive in ensuring that they have robust anti-corruption procedures in place.

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## **The proposed US Arbitration Fairness Act would abrogate UN Arbitration Treaty and force US franchisors to enforce and defend claims only in foreign courts**

**T**he concept of arbitration in the US is under assault. The proposed Arbitration Fairness Act and recent California court cases call into question the continued viability of enforcing pre-dispute arbitration clauses contained in franchise agreements. Without the benefit of an enforceable arbitration clause, US franchisors will be forced to seek

alternative, and often uncertain, remedies for enforcing claims against their foreign franchisees.

### **Background**

The US is not party to any treaty that provides for enforcement of judgments from US courts in other countries.

Although some foreign courts will enforce US court judgments as a matter of comity,<sup>1</sup> many significant US trading partners refuse to recognise and enforce judgments from the US.<sup>2</sup>

Because the US Congress has refused to adopt legislation that would establish a national standard for enforcing foreign judgments in US courts, the country's state law, rather than federal law, has governed and continues to govern this area.<sup>3</sup> US state law is not uniform.

One attempt to establish uniformity in the recognition of foreign judgments is the Uniform Foreign Money Judgment Recognition and Enforcement Act. Thirty-two US states have adopted some form of the Recognition Act, which establishes standards for enforcing foreign money judgments in courts in those states.<sup>4</sup> Other states frequently enforce foreign judgments as a matter of comity.<sup>5</sup> However, the goal of the Recognition Act, to 'make it more likely that judgments rendered in the state will be recognised abroad', has yet to be satisfied in many cases.<sup>6</sup> In other words, foreign judgments are likely to be enforced in US courts against US franchisors, but foreign courts are unlikely to enforce US judgments against foreign franchisees.

In the franchise context, a US franchisor hoping to enforce its claims against a foreign franchisee must closely analyse whether the country where a franchisee resides or carries on business would be likely to enforce a US court's judgment before the franchisor spends the time and money required to litigate in the US.<sup>7</sup> If enforcing such a court judgment is unlikely, a US franchisor has only two options: submit to the jurisdiction of the courts where their foreign franchisees live or arbitrate the claims. Because of their unfamiliarity with foreign court systems, the differences in language, procedures and claims, most US franchisors prefer to avoid litigation in foreign courts.

### The New York Convention

If a suit in a US court is impractical, the only alternative a US franchisor has to litigating claims in a franchisee's home courts is arbitration.<sup>8</sup> The 1958 New York Convention on the Recognition and Enforcement of Foreign Arbitral Awards is a treaty, which has been adopted by 144 countries, including the US.<sup>9</sup> Under

its rules 'contracting states', with some exceptions, must enforce arbitral awards rendered by tribunals in other 'contracting states.' Additionally, 'each contracting state shall recognise an agreement in writing under which the parties undertake to submit to arbitration all or any differences which have arisen or which may arise between them in respect of a defined legal relationship, whether contractual or not, concerning a subject matter capable of settlement by arbitration.'<sup>10</sup>

For example, if a US franchisor and an English franchisee resolve their dispute as specified in an arbitration clause in their franchise agreement in New York, the arbitral award will be enforced by English courts against the English franchisee. The New York Convention avoids the problem of enforcing US court judgments against foreign franchisees and also eliminates much of the uncertainty US franchisors face when litigating claims against foreign franchisees in the franchisees' home courts. That is why international franchise agreements used by US franchisors usually require most disputes to be resolved by arbitration.

### The Arbitration Fairness Act

The proposed Arbitration Fairness Act, HR 1020, now pending in Congress, would undermine US treaty obligations<sup>11</sup> and deprive US franchisors of their right to require claims against foreign franchisees to be arbitrated in the US.<sup>12</sup> The proposed Act, as currently drafted, makes pre-dispute arbitration clauses in franchise agreements void, without any distinction between international and domestic franchise agreements.<sup>13</sup> Instead of recognising agreements to arbitrate disputes between parties from contracting states, US law would bar the enforcement of those agreements.

In the bill a franchise dispute is defined as a 'dispute between a franchisor and franchisee arising out of or relating to a contract or agreement by which a franchise is granted the right to engage in the business of offering, selling, or distributing goods or services under a marketing plan or system prescribed in substantial part by a franchisor; the operation of the franchisee's business pursuant to such plan or system is substantially associated with the franchisor's trademark, service mark, trade name,

logotype, advertising, or other commercial symbol designating the franchisor or its affiliate; and the franchisee is required to pay, directly or indirectly, a franchise fee.<sup>14</sup> The pertinent language of the proposed Act states:

- (b) No pre-dispute arbitration agreement shall be valid or enforceable if it requires arbitration of –
    - '(1) an employment, consumer, or franchise dispute; or
    - '(2) a dispute arising under any statute intended to protect civil rights.
- (Section 2. (b)).

HR 1020 is aimed at preventing mandatory arbitration clauses from being enforceable against parties of unequal bargaining power. In the franchise context, the proposed Act would force both domestic and international franchise disputes that would have previously been resolved in arbitration into the courts.

If enacted, it is possible that the Contracts Clause of the US Constitution would prohibit retroactive application of the proposed Act to the thousands of contracts that already have pre-dispute arbitration clauses.<sup>15</sup> Prospectively, however, the proposed Act would effectively force US franchisors with foreign franchisees to submit themselves to the jurisdiction of foreign courts if they wish to bring suit against their foreign franchisees. The proposed Act also would likely void arbitration clauses in franchise agreements between foreign franchisors and US franchisees.

### **California cases limit franchise claim for arbitrability**

HR 1020 reflects a growing concern about the use of arbitration as a dispute resolution procedure in the US. California courts, in particular, often are asked to compel parties to arbitrate. If a franchisee ignores an arbitration clause in a franchise agreement and brings its claims in court, a franchisor will petition the court to enforce the arbitration clause by ordering the franchisee to engage in arbitration.<sup>16</sup> In the light of recent court cases, California courts now examine arbitration clauses to determine if they are procedurally and substantively unconscionable. The seminal case that began this recent trend is *Nagrampa v MailCoups, Inc*, 469 F 3d 1257 (9th Cir

2006). In *Nagrampa*, the Ninth Circuit Court of Appeals, applying California law, invalidated a specific arbitration provision in a franchise agreement on the grounds that it was procedurally and substantively unconscionable.<sup>17</sup> The court held that the provision was procedurally unconscionable because the franchisor had overwhelming bargaining power, drafted the contract, and presented it to the franchisee on a take-it-or-leave-it basis.<sup>18</sup> The court further held that the arbitration clause was substantively unconscionable because, among other things, it:

- lacked mutuality by reserving the franchisor's right to bring intellectual property actions against the franchisee in court, while requiring the franchisee to submit all claims against the franchisor in arbitration; and
- contained a forum selection clause designating the franchisor's home state, Massachusetts, as the forum for arbitration.

The arbitration clause was found to be oppressive to the franchisee due to the parties' unequal bargaining power. The clause would require the franchisee, who resided in California, to fly across the country to Massachusetts, thereby incurring additional travel and living expenses and increased costs associated with having counsel familiar with Massachusetts law, to arbitrate a contract signed and performed in California.<sup>19</sup>

Courts also have held the following standard provisions of franchise arbitration clauses to be substantively unconscionable under California law:

- a reduction of the statute of limitations for bringing a claim;
- a waiver of the right to seek or obtain punitive damages; and
- a waiver of the right to have claims decided in a class action.<sup>20</sup>

Most franchise agreements designate a forum, which is typically where the franchisor has its principal place of business, although international franchise agreements sometimes designate a 'neutral' forum in a country where neither the franchisor nor the franchisee reside. Moreover, because decisions relating to ownership of intellectual property are critical to franchise companies and because no right of appeal from arbitral decision is generally allowed, franchisors normally



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exclude disputes relating to intellectual property from arbitration. To further facilitate protection of intellectual property rights and to take advantage of the speed of interlocutory remedies which are readily available through courts, franchisors regularly expressly reserve the right to seek preliminary injunctions and other interlocutory relief in courts. The Ninth Circuit in *Nagrampa* has concluded that under California law these practices are substantively unconscionable because only franchisors are allowed access to courts and franchisees may resort only to arbitration for resolution of their claims. Thus, the arbitration clauses have been rendered unenforceable.<sup>21</sup>

### Dealing with California cases

One alternative, at least in California, would be to draft a 'conscionable' arbitration provision, taking into account the principle of mutuality and removing certain provisions that the California courts find unconscionable, such as the reduction of the statute of limitations for bringing a claim, waiver of punitive damages, and waiver of class actions.<sup>22</sup> But eliminating the venue selection clause<sup>23</sup> and a franchisor's right to have intellectual property claims heard in court and a franchisor's right to obtain preliminary relief in court may so substantially undermine the perceived benefits of arbitration that franchisors will abandon it.

### Is arbitration about to be eliminated?

Why would Congress consider depriving US businesses of a remedy, especially at a time when international franchising activity is at an all time high and expected to expand still further? Why are courts in California and Montana refusing to enforce arbitration agreements which designate a foreign state venue or which exclude intellectual property claims and interlocutory remedies from arbitrations? Disputes between franchisors and their international franchisees are often disputes between sophisticated parties and do not represent an imbalance of bargaining power which is one of the stated premises for the legislation. It appears that the sponsors have yet to consider the impact of the bill on international franchise transactions.

Supporters of the proposed Act claim

that binding arbitration is inherently unfair because, among other things, it is:

- difficult and often impossible to have an arbitration decision reviewed by a court; expensive and the franchisee must typically pay half of the fees charged by arbitration tribunals upfront before a hearing may begin;
- often in the franchisor's home town where the pool of potential arbitrators may be biased in favour of the franchisor;
- limited in discovery, making it difficult for the franchisee to uncover evidence related to its case;
- used to limit the type of claims brought, often excluding class actions or association lawsuits; and
- biased in favour of the franchisor, which regularly uses the services of the arbitration organisation.<sup>24</sup>

Even if HR 1020 is never enacted, California-based international franchisors should be evaluating the dispute resolution language in their franchise agreements. For some the problems may be mitigated by establishing their international franchising headquarters in a state with more favourable laws. For others, especially if they are concerned about HR 1020 becoming law, the solution may be to establish their international franchising operations offshore in a jurisdiction that is a contracting state to the New York Convention. Further, US franchisors would likely try to negotiate and draft contracts with as few contacts with California and the US as possible so as to avoid the application of California and US law.<sup>25</sup>

The current uncertainty of the enforceability of arbitration agreements in California and Montana would be compounded by the enactment of HR 1020. As it is currently drafted, the proposed Act is almost certain to have a negative impact on US companies franchising abroad and on foreign franchisors franchising in the US. Given these uncertain times, the franchising community should re-evaluate their franchise agreements and consider whether they want to continue to use arbitration clauses in their franchise agreements.

### Notes

- 1 'Comity' is the recognition which 'one nation allows within its territory to the legislative, executive or judicial acts of another nation, having due regard

- both to international duty and convenience, and to the rights of its own citizens or of other persons who are under the protection of its laws.' *Hilton v Guyot*, 159 US 113, 163-64 (1895).
- 2 Brazil, Switzerland and France will not enforce a judgment against their nationals unless there is a 'clear indication' that the national intended to submit to the foreign court's jurisdiction. *See Fredric D Tannenbaum*, International Contracts: Practical Considerations to Maximize Enforcement, in Ali-Aba's Practice Checklist Manual on Advising Business Clients II: Checklists, Forms and Advice from The Practical Lawyer 325 (Mark T Carroll ed., 2000). Several nations, including most of the Nordic countries, the Netherlands and Saudi Arabia, will not recognise a foreign judgment absent the existence of a convention or treaty covering judgments between the 'rendering' and 'recognising' jurisdictions. *Id.* Some foreign courts view certain features of US law – including jury awards, punitive damages, treble damages – as contrary to their own public policy. *See Nadja Vietz, Will Your US Judgment Be Enforced Abroad?*, Washington State Bar Association, March 2009, [www.wsba.org/media/publications/barnews/mar09-willyourusjudgmentbeenforcedabroad.htm](http://www.wsba.org/media/publications/barnews/mar09-willyourusjudgmentbeenforcedabroad.htm). A number of nations require reciprocity of treatment of their courts' judgments in the courts of the nation that rendered the judgment to be enforced. For some nations, such as Singapore, the requirement of reciprocity may be met only where its government has formally concluded that reciprocity exists between the courts of those two nations. *See Reciprocal Enforcement of Foreign Judgments Act 1959* (Cap 265, 2001 Ed.).
  - 3 Jay R Server, *The relaxation of inarbitrability & public policy checks in US and foreign arbitration: Arbitration out of control?*, 65 Tul L Rev 1661, 1663 (1991). *See, e.g., Tonga Air Services, Ltd v Fowler*, 826 P.2d 204, 208 (Washington 1992) (procedure for recognition and enforcement of foreign country judgments is similar in all states, with some following the common law, and others the Recognition Act which reflects the common law).
  - 4 A Few Facts about Uniform Foreign Money Judgments Recognition Act, [www.nccusl.org/Update/uniformact\\_factsheets/uniformacts-fs-ufmjra.asp](http://www.nccusl.org/Update/uniformact_factsheets/uniformacts-fs-ufmjra.asp), last visited 7 December 2009. The Recognition Act codified the majority views under the common law of recognition and enforcement. The most significant area of nonuniformity in covered by the Recognition Act deals with the issue of reciprocity. Six states (Florida, Idaho, Maine, North Carolina, Ohio and Texas) provide a discretionary basis for non-recognition of judgments on the grounds of lack of reciprocity. *See Margaret A Dale, Proskauer on International Litigation and Dispute Resolution: Managing, Resolving, and Avoiding Cross-Border Business or Regulatory Disputes*, Ch 18 (2009), [www.proskauerguide.com/litigation/18/I](http://www.proskauerguide.com/litigation/18/I). In Massachusetts and Georgia, the lack of reciprocity is a mandatory ground for non-recognition of judgments. *Id.* Further, Colorado has defined 'foreign state' to include only those states that have entered into a reciprocal arrangement with the US recognising a judgment of a US court. *Id.* Since the US has not entered into any such agreements, it appears that Colorado's version of the Act would never result in the recognition of a foreign judgment. *Id.* However, Colorado has recognized foreign judgments under principles of comity. *Id.*
  - 5 As a general rule, comity may be granted where 'it is shown that the foreign court is a court of competent jurisdiction, and that the laws and public policy of the forum state and the rights of its residents will not be violated.' *Cunard S S Co v Salen Reefer Serv AB*, 773 F.2d 452, 457 (2d Cir 1985).
  - 6 Uniform Foreign Money Judgments Recognition Act, 13 U L A 261 (1986) (citing the original 1962 Prefatory Note to the Act). The fragmented approach regarding the enforcement of foreign judgments in the US has defeated one of the key goals of the Uniform Recognition Act, 'fostering a better climate for American litigants abroad by communicating to foreign nations that their judgments would be recognised in the United States.' Saad Gul, *Old Rules for a New World? The Constitutional Underpinnings of US Foreign Judgment Enforcement Doctrine*, 5 Appalachian J L 67, 89 (2006). Instead, "[t]he piecemeal adoption of the Act across the nation, with varying reciprocity requirements has defeated this purpose." *Id.*
  - 7 Whether the courts of a foreign country would enforce a judgment issued by a US court depends upon the laws of the foreign country and comity. In many countries, as in most jurisdictions in the US, the recognition and enforcement of foreign judgments is governed by domestic law and the principles of comity, reciprocity and res judicata. *See Hilton v Guyot*, 159 US 113 (1895); 47 Am Jur 2d, *Judgments*, § 1214, et seq. The general principle is that a foreign nation claims and exercises the right to examine judgments for four causes: (1) to determine if the court had jurisdiction; (2) to determine whether the defendant was properly served; (3) to determine if the proceedings were vitiated by fraud; and (4) to establish that the judgment is not contrary to the public policy of the foreign country. Hartwin Bungert, *Enforcing Excessive and Punitive Damages Awards in Germany*, 27 Int Law 1075, 1090 (1993). While procedures vary widely from country to country, judgments which do not involve multiple damages or punitive damages generally may be enforced upon recognition as authoritative and final unless domestic law mandates a treaty obligation. *Id.*
  - 8 In international transactions, arbitration is widely accepted as the standard vehicle for dispute resolution because it allows parties to select a neutral forum and to enforce awards across borders. *See Edna Sussman, The Unintended Consequences of the Proposed Arbitration Fairness Act*, 56 Fed Law 49 (May 2009). To preserve arbitration and prevent damage to US business interests, it is vital to enforce pre-dispute arbitration agreements.



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- Post-dispute arbitration agreements are not a viable alternatives, because, parties that prefer arbitration when entering into a contract would likely choose to delay any proceedings and to turn to a court forum that is favorable to them. *Id.*
- 9 New York Arbitration Convention, New York Convention Countries, [www.newyorkconvention.org/new-york-convention-countries](http://www.newyorkconvention.org/new-york-convention-countries), last visited 7 December 2009.
- 10 New York Convention on the Recognition and Enforcement of Foreign Arbitral Awards, art. II, 1, 10 June 1958, 21 U N S T 2518.
- 11 The proposed Act would put the US at risk of breaching its treaty obligations as a signatory to the New York Convention. As noted by the Supreme Court, the New York Convention was ‘to unify the standards by which agreements to arbitrate are observed and arbitral awards enforced in the signatory countries.’ *Scherk v Alberto-Culver*, 417 US 506, 520 (1974). Treaty obligations can be terminated in a variety of ways. Congress may pass a law inconsistent with the terms of the treaty, and the courts will enforce the law at the expense of the treaty. Congress can pass a joint resolution that directs the President to abrogate, or nullify, a treaty; or the President can request a Senate resolution consenting to abrogation of a treaty. Finally, the President can abrogate a treaty unilaterally, without obtaining the consent of Congress or the Senate. In order to resolve inconsistencies between treaties and other international agreements and domestic law, two rules of interpretation have been developed: (1) when an Act of Congress and an international agreement relate to the same subject, the Executive Branch and the courts will endeavor to construe them so as to give effect to both; or (2) when reconciling the international agreement and an Act of Congress, the later in time generally prevails as domestic law. If application of these rules results in supersession of treaty provisions as domestic law, that result does not relieve the United States of its international obligations. See Robert E. Dalton, *National Treaty Law and Practice: United States*, Washington DC: American Society of International Law 13-15, (Monroe Leigh, Merritt R Blakeslee, and L Benjamin Ederington eds., 1999).
- 12 As amended by this Act, the Federal Arbitration Act would now cover three additional categories of disputes: employment disputes, consumer disputes, and franchise disputes. Arbitration Fairness Act of 2009, H R 1020 111th Congress (2009).
- 13 This prohibition will invalidate arbitration agreements including international agreements that reflect negotiated terms between sophisticated parties – agreements that Congress has no reason to invalidate if the intent of the proposed act is to ‘regulate contracts or transactions between parties of unequal bargaining power.’ See Edna Sussman,

*The Unintended Consequences of the Proposed Arbitration Fairness Act*, 56 Fed Law 49-50 (May 2009).

- 14 Arbitration Fairness Act of 2009, H R 1020 111th Congress (2009).

15 See, e.g., *Holiday Inns Franchising, Inc v Branstad*, 29 F 3d 383 (8th Cir 1994) (holding that retroactive application of the Iowa Franchise Act to existing franchise agreements was unconstitutional under the Contracts Clause of both the US and Iowa constitutions). The Contract Clause appears in the United States Constitution, Article I, section 10, clause 1. It forbids any state from passing a law that retroactively impairs the obligation of contracts. However, as the proposed Act makes clear, the Act would take effect on the date of enactment ‘and shall apply with respect to any dispute or claim that arises on or after such date,’ therefore arguably meaning that disputes arising under previously drafted franchise agreements would be subject to these new requirements, and those disputes previously automatically resolved by arbitration would now require the parties’ explicit agreement at the time the dispute arises for arbitration to remain as the mechanism to resolve the dispute. Arbitration Fairness Act of 2009, H.R. 1020 111th Congress (2009).

- 16 Arbitration, 9 U S C § 4 (2009).

17 Although most state courts have yet to interpret their laws relating to arbitration clauses as California has, California contains twenty percent of the US population, and its decisions often are followed by courts in other states. Approximately 20 per cent of US franchisors are based in California and virtually all major US franchisors have franchisees in California.

- 18 *Nagrampa*, 469 F 3d at 1284.

19 *Id.* at 1286-88.

20 *ILJ Dominicana S A v It's Just Lunch Int'l, LLC*, 2009 US Dist LEXIS 13689, \*9-13 (C.D. Ca. 2009) (finding waiver of punitive damages and bar on class actions in arbitration provision of franchise agreement to be substantively unconscionable).

21 In a case applying Montana law, the Ninth Circuit has found that a Maryland choice of law clause in the arbitration provision in an agreement for the establishment and operation of a hotel franchise in Montana was unconscionable and would contradict Montana public policy. *Ticknor v Choice Hotels International, Inc*, Business Franchise Guide (CCH) ¶12,156 (9th Cir. 2001). In that case, the franchisee had signed a franchise agreement with Choice Hotels International, Inc. and subsequently breached his franchise agreement by suspending his payment of franchise fees. Choice Hotels then suspended the franchise agreement and demanded arbitration, pursuant to the arbitration clause in the parties’ agreement. Applying Montana state law, the Ninth Circuit found that the arbitration provision was unconscionable because the franchisor reserved for itself the right to litigate certain matters, while the franchisee was required to arbitrate all disputes, thus the arbitration provision lacked mutuality of obligation, was one-sided, and contained terms

that were unreasonably favorable to the drafter – the franchisor. The court also found that the franchise agreement was one of adhesion under state law. Thus, the court concluded that because the franchise agreement was an adhesion contract, the unconscionable arbitration provision was unenforceable.

- 22 *ILJ Dominicana S.A.*, 2009 US Dist LEXIS at \*9-13.
- 23 *Nagrampa*, 469 F 3d at 1286-88; *see also Bridge Fund Capital Corp v Fastbucks*, 2008 WL 387634, \*5 (E D Cal, 20 August 2008) (finding substantive unconscionability based on forum selection naming Texas as the venue for arbitration because transferring the action or applying Texas law would run afoul of California's public policy).
- 24 Carmen D Caruso, *Support The Arbitration Fairness Act of 2009*, The Bottom Line, 10-11 (September 2009).
- 25 The proposed Act could mark the US as a jurisdiction

no longer considered a friendly forum for arbitration. According to a Recommendation adopted by the American Bar Association, if that were to happen, the US's reputation as a forum to be avoided for arbitrations would create problems for US franchisors attempting to do business abroad. Foreign parties would avoid US partners, knowing that it was likely pre-dispute arbitration agreements with those partners would not be honoured in the US and that all arbitrations could be subject to lengthy court delays. US court process is often viewed, especially by foreign companies, as much more expensive, burdensome and intrusive on company executives' and employees' time. For example, the discovery rules in the US are significantly more expansive than those of other jurisdictions. *See American Bar Association, Recommendation, Adopted by the House of Delegates 114, 3-4 August 2009.*

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