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Franchise Disclosure Documents and Agreements

Who's Writing Them?

By Nicholas Bibby

While franchise disclosure documents and their attendant agreements are the "glue" applied to the initial franchisor/franchisee relationship, the question of "who constructed the paperwork" is both a touchy and legitimate concern for those immersed in the franchise industry.

WHO DOES WHAT

Historically, three distinct elements have assumed responsibility for developing the documents (although few know or admit that this development trio exists because, and especially within the non-franchise universe, documents penned for legal purposes are normally thought of as attorney-generated). The three groups of players are: attorneys (with or without franchise expertise); franchisors (both active and emerging); and consultants (ranging from brokers whom the industry continues to accept with the self-absorbed title of "consultant" to fee-for-service types). And, just as the franchise industry itself is made of up of divergent personalities, business segments (at least 100), experiences, goals, knowledge, and trust levels, it's also true that the individuals designing documents and agreements are equally, if not more, diverse in all respects.

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AAA Reduces Fees in Pilot Program

By Kevin Adler

The American Arbitration Association ("AAA") is reporting that its pilot program to reduce commercial arbitration fees has been popularly received, and AAA is increasing its promotion of the new fee structure. The program began in July 2009 and has been utilized in 1,000 to 2,000 disputes to date, reflecting claims totaling nearly $3 billion, according to India Johnson, an AAA senior vice president. The number of those disputes related to franchising is unknown.

WHAT THE PROGRAM ENTAILS

The pilot program includes a low Initial Filing Fee to start an arbitration procedure, and then a Proceed Fee if either party wishes to pursue selection of an arbitrator. Under the Standard Fee Schedule for commercial arbitration, filing for a claim of up to $10,000 would incur a fee of $775, plus $200 if the case is heard. Under the pilot program, that same claim would incur a $300 Initial Filing Fee; if the parties moved forward to pursue arbitration, they would be charged a $550 Proceed Fee, as well as $200 if the case is heard (*see* table on page 2).

"Arbitration is about having alternatives and options, and we believe that this new fee structure is one way to give people more options for getting what they want," said Johnson. "Arbitration fees have been front-loaded because we assumed that when people filed for arbitration, they wanted to arbitrate. But this program recognizes that, in some situations, they do not necessarily intend to arbitrate; they really want to negotiate with the other party, but the filing is needed to get a response from the other party and to see where they stand."

THE FEE STRUCTURE

The two-part fee structure enables a party to begin the process with minimal cost and, hopefully, to resolve the dispute before going to an arbitration hearing. When a party pays the Initial Fee, the other party has a limited time to respond, usually 15 days. The file will remain open for 90 days, during which the parties can try to resolve the conflict. If they resolve it, then the file is closed.

If instead the parties decide to proceed with arbitration, a Proceed Fee will be charged. This fee will vary based on the size of the claim and whether AAA is

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AAA Reduces Fees

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asked to furnish a list of arbitrators. If the parties agree on an arbitrator without seeking AAA's input, the fee is halved. "Some outside counsel conduct a lot of arbitrations," said Johnson. "We recognize that they are familiar with arbitrators, and often with opposing counsel as well, and they can agree on their choice of arbitrator without us. So we do not need to charge the full fee."

Attorneys' Reactions Mixed

Franchise attorneys said that, while they support the new fee program, they have additional concerns. "I welcome fee reductions, but remember that it does come with a lot less service," said Harry M. Rifkin, practice leader for the Franchise & Business Law Group (Lutherville, MD). "It could work if you know what you are doing, such as in selecting an arbitrator."

Carl Zwisler, a principal with Gray Plant Mooty in Washington, DC, cautioned that the majority arbitration costs are incurred through fees paid to layers, arbitrators, and expert witnesses, none of which are reduced by the new fee structure. "No one with experience in litigation dares to make the decision to file based upon the initial filing fee," he said. "Once an arbitration or litigation begins, the parties have relatively little control over what the total cost will be."

Zwisler also questioned whether the new fee structure would induce an increase in arbitration filings aimed at negotiating a settlement. "In my experience, most franchise arbitration demands are drafted like complaints filed in court, and the claimant/plaintiff usually expects the case to proceed," he said. "Most clients and lawyers I know have already tried to negotiate resolutions of problems before they file, so I doubt that a lower initial filing fee will increase the number of filings. I also doubt that a reduced filing fee will result in a settlement. The current filing fee required for a counterclaim actually may expedite settlements because defendants realize they must spend money out-of-pocket to proceed."

Furthermore, some of the objections that attorneys have to arbitration, especially attorneys working on behalf of franchisees, cannot be addressed through fees, said Rifkin. He cited the secrecy of the process and the inherent interest of an arbitrator in getting cases to arbitrate. "Fees are only one of many problems with arbitration that have arisen over the last 20 years," said Rifkin. "The whole system is based on attracting repeat customers, which you can achieve by making them believe they will get a favorable outcome … . [In a franchising context], an arbitrator who starts ruling consistently against franchisors will not get more work from franchisors. This isn't to suggest

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Kevin Adler is the Associate Editor of this newsletter.

American Arbitration Association Pilot Flexible Fee Schedule
(In effect for cases filed through May 30, 2010. Subject to change or cancellation.)

Amount of claim	Initial Filing Fee	Proceed Fee*	Final Fee
Up to $10,000	$300	$550	$200
Above $10,000 to $75,000	500	600	300
Above $75,000 to $150,000	500	1500	750
Above $150,000 to $300,000	500	2,525	1,250
Above $300,000 to $500,000	1,000	3,750	1,750
Above $500,000 to $1 million	1,000	5,600	2,500
Above $1 million to $5 million	1,000	7,800	3,250
Above $5 million to $10 million	2,000	9,000	4,000
Above $10 million	2,500	11,500 plus 0.1% of claim amount over $10 million, up to $65,000	6,000
Non-monetary**	1,000	2,750	1,250
Consent award***			

* Where an arbitrator has been pre-selected and appointed by the parties, the Proceed Fee will be reduced by 50%.
** This fee is applicable only when a claim or counterclaim is not for a monetary amount. Where a monetary amount claim is not known, parties will be required to state a range of claims or be subject to the highest possible filing fee.
*** The AAA may assist the parties with the appointment of an arbitrator for the sole purpose of having their consent award signed. Contact AAA at 800.778.7879 for more information.

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COURT WATCH

By Charles G. Miller and Darryl A. Hart

Pennsylvania Choice of Law Clause Works in California

In *Portnoy v. Dollar Financial Corp.*, Bus. Franchise Guide (CCH), 14, 252 (C.D. Cal. Aug. 11, 2009), a We The People franchisee sued the franchisor and parent companies in California. The franchise agreement had a Pennsylvania choice-of-law provision because the franchisor and parent were Pennsylvania companies. It also had an arbitration agreement requiring arbitration in Pennsylvania. Under the arbitration clause, the arbitrator's authority was limited to the extent he or she could not extend, modify, or suspend the terms of the agreement or stay, rescind, or postpone any termination. Further, damages were limited to actual damages; no others, including punitive damages or lost profits, could be awarded. The franchisor moved to compel arbitration, and the franchisee argued that the arbitration agreement was unconscionable because it required arbitration in Pennsylvania, contrary to the California Franchise Relations Act, and because of the two other provisions discussed above. The court granted the motion and upheld the arbitration provision based on Pennsylvania law.

The franchisee argued that the court should not apply Pennsylvania law because it would violate the public policy of California evidenced by the California Franchise Relations Act, which voided clauses requiring franchisees to litigate in another state (Cal. Bus. & Prof. Code § 20040.5). The court rejected this argument on the basis that the issue was not whether the franchisee had to arbitrate in Pennsylvania, but whether a fundamental California public policy was impacted simply as a result of applying Pennsylvania law to whether the franchisee had to arbitrate in Pennsylvania. The court also noted that adopting the franchisee's position would result in enforcing Business and Professions Code section 20040.5 in every instance, even though that provision has been preempted by the Federal Arbitration Act.

The franchisee also argued that Pennsylvania law should not apply because it would negate his California little FTC Act claim (based on fundamental public policy), which depended on application of California law. Interestingly, the court rejected this argument and found that the little FTC Act claim was nothing more than a restatement of the common law claims based on fraud, breach of contract, conversion, etc., and that plaintiff had failed to show that Pennsylvania law could not adequately address those claims.

Getting to the issue of unconscionability, the court determined that the arbitration clause was not procedurally unconscionable under Pennsylvania law, and thus never got to the issue of whether it was substantively unconscionable. Even though the contract was one of adhesion, the court said that it was not automatically unenforceable. The franchisee would still have to show that it was unconscionable due to the relative bargaining positions of the parties and the degree of economic compulsion placed on the adhering party. While there was a great imbalance in the bargaining position of the parties, the court held that there was no economic compulsion because the franchisee was not forced to buy a We The People franchise and could have "walked away from the Agreement and purchased another franchise if he so chose."

Another Unconsconability Claim

In another recent case involving claims of unconscionability, the California Court of Appeal granted a writ and refused to enforce an arbitration clause in a precious metals investment contract because it determined that the requirement of having three JAMS arbitrators made the costs of the arbitration unconscionable. The case is important in the franchise context because it extended principles developed in the California employment cases to franchises, as was done earlier in *Independent Assn. of Mailbox Center Owners, Inc. v. Superior Court* (*Mail Boxes Etc., USA, Inc.*) (2005)133 Cal.App.4th 396, 34 Cal.Rptr.3d 659. The case is noteworthy because the decison was not expressly based on the ability of an investor to advance statutorily protected claims grounded in public policy (such as certain employment claims or Franchise Investment Law claims), but simply involved common law claims. There was an unfair competition claim under California's little FTC Act, presumably dependent on the common law claims, like in the *Portnoy* case above, but this did not drive the court's decision.

The decision also left open the door for a defendant to argue in a different case that the arbitrator must decide the issue of unconscionability. Observing that *Howsam v. Dean Witter Reynolds, Inc.* (2002) 537 U.S. 79, 83 indicated that the parties could relegate the issue to an arbitrator if their intent to do so was "clear and unmistabeable," the court said that such clear intent was not present in the particular case before them because the "severability" provision in the contract gave the "trier of fact of competent jurisdiction" the power to sever any unenforceable provision. The court determined that the "trier of fact of competent jurisdiction" encompassed more than just an arbitrator or panel of arbitrators.

The court found the arbitration agreement procedurally unconscionable because it was part of an adhesion contract, but determined that it was of a low or medium degree of procedural unconscionability, due to the fact that the arbitration provisions were not hidden and the investors could have chosen other investments.

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On the latter note, contrary to the *Portnoy* decision above, the court determined, based on *Nagrampa v. Mailcoups, Inc.* (9th Cir. 2006) 469 F.3d 1257, 1283, that the existence of reasonable alternatives alone will not defeat a finding of procedural unconscionability.

Turning to the question of substantive unconscionability, the court undertook an excellent analysis of the various approaches taken by state and federal courts on the question of allocation or shifting of arbitration fees, and concluded that in the case at hand, the requirement of three JAMS arbitrators costing over $6,000 per day for each side was unconscionable, given the financial position of the plaintiffs and the inability of the defendant to articulate a reason for needing three arbitrators. The defendant even told the court it would agree to only one arbitrator, but the court rejected that because the arbitration clause must be tested as of the time the contract was entered into.

The court refused to sever the objectionable clauses (even after the franchisor said it would agree to one arbitrator) mainly because it found that the defendant might have drafted the non-consolidation provision together with the three-arbitrator requirement with knowledge that they might not withstand scrutiny, showing it did so for the improper purpose of discouraging the claimants from pursuing their legal rights.

Kodak-Based Lock-in Claim Allowed to Go Forward

In *Burda, et al v. Wendy's International, Inc., et al* Bus. Franchise Guide (CCH) 14,240 (USDC, S.D. Ohio, Sept. 21, 2009), the court heard the defendants' motion to dismiss a tying claim made by a multi-unit franchisee of Wendy's. When plaintiff Burda signed 13 Unit Franchise Agreements with Wendy's, Wendy's allowed various suppliers to provide products to its franchisees. Somewhat later, Wendy's designated a bakery operated by a Wendy's subsidiary as the exclusive source from which Wendy's franchisees in Burda's area could purchase their hamburger buns. Some years later, Wendy's also required its franchisees to purchase other food items only from a company in which Wendy's had an interest or, if they purchased those supplies elsewhere, required suppliers to add a 4% per case surcharge on items sold, making the cost of those items from alternate suppliers prohibitive.

The plaintiffs' complaint alleged that the above-described limitations and conditions amounted to a "lock-in" whereby Wendy's used its franchise rights to compel its franchisees to purchase buns and food items from Wendy's designees. Wendy's moved to dismiss the antitrust claims on the basis that the plaintiffs had failed to adequately plead a relevant market over which Wendy's had sufficient market power to compel the plaintiffs to purchase the designated products or that there was a lock-in which would take the place of market power. It also maintained that the plaintiffs' claims sounded only in contract since the requirement that the plaintiffs purchase designated items arose out of Wendy's standard unit franchise agreement and not from a tying arrangement. Wendy's also maintained that since the plaintiffs' franchise agreements were signed over four years prior to the complaint, the statute of limitations had lapsed on the claims.

Normally, in order for there to be an illegal tying arrangement, the seller of the tied product must have significant market power in the tying product in the relevant geographic market, and the arrangement must affect a substantial volume of commerce in the tied product. However, in *Eastman Kodak Company v. Image Technical Services, Inc.*, 504 U.S. 451 (1992), the U.S. Supreme Court held that market power is inferred if a customer is "locked-in" by purchasing an expensive unique product which the vendor was later able to use to compel the purchase of other items that were previously available from other sources — in the case of Kodak, it was parts used to repair its copiers. By not providing its unique repair parts to independent copier repair providers, Kodak, as a practical matter, compelled its copier owners to use its own repair service. The key in *Kodak* was that at the time its copier owners purchased their Kodak equipment, they were not made aware of the company's ability to cut independent repair providers out of the repair business by a later change of policy, and, thus, the copier buyers could not anticipate this more-expensive alternative in their initial purchasing decisions.

In *Burda*, the concerned provision in the Wendy's franchise agreement stated, in part, that franchisees could only purchase items from suppliers who satisfied Wendy's that they could meet its standards and were approved. While there is less-than-unanimous authority that a franchise can be a tying product, the *Burda* court concluded that the franchise rights were the tying product and the food items were the tied products. The issue then was whether the lock-in was obviated because the plaintiffs had notice that Wendy's could limit the plaintiffs' supplier options, based on the language of the franchise agreement, which informed the plaintiffs that Wendy's had control over which suppliers it approved. Since this issue is fact-based, it could not be disposed of in the context of a motion to dismiss. However, the court indicated that the concerned section of the franchise agreement gave no indication that competition could be limited at the whim of Wendy's, but rather that Wendy's standards and specifications, as well as a few other criteria, provided the only limitation on supplier competition.

A similar case, *Queen City Pizza, Inc. et al v. Domino's Pizza, Inc.*, 124 F.3d 430 (USCA 3d Cir, 1997), was distinguished by the *Burda* court on the basis that the Domino's franchise agreement mentioned that Domino's could designate itself or its designees as exclusive distributors of specified items. As such, even though there was a lock-in after the Domino's franchise was purchased, prospective franchisees had sufficient information regarding this aspect of the franchise in order to determine

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NEWS BRIEFS

Quiznos and Franchisees Reach Settlement Of Multiple Class Action Lawsuits

Sandwich franchise Quiznos has agreed to settle four class-action lawsuits with franchisees and prospective franchisees, and the settlement received preliminary approval on Nov. 23 by U.S. District Court Judge Rebecca Pallmeyer. The cases were filed in Colorado, Wisconsin, and Illinois, beginning in 2006.

"This is a monumental achievement. It covers all class actions that I know of pending against Quiznos in the United States," said Justin M. Klein, one of the attorneys for the plaintiffs. "Our focus was on trying to get a result that created changes in what franchisees feel are problems in the Quiznos system. It reflects what we believe is a positive step for the future of the Quiznos system."

Quiznos denied all claims, and the settlement agreement involves no finding or admission of liability. In a prepared statement, the company said it is "pleased with the terms of the settlement. Litigation is a time-consuming process that shifts valuable time and resources away from our most important focus — great-tasting food, franchise-owner profitability, and customer satisfaction."

Among the key developments is that Quiznos agreed to recognize a new independent franchisee association and to fund its startup. "This is very important because it will allow franchisees to have a direct voice to the corporation … which has been an issue in the past," said Klein.

Quiznos has had contentious relations with franchisees seeking to create an independent association since at least 2005, when the Quiznos Franchisees Association was formed by a disgruntled franchisee in California. The company founded the Quiznos Franchise Association, which is not an independent franchisee organization.

The settlement also includes about $95 million in payments and credits for past and current franchisees, focusing on the franchise sales process, advertising support, and the company's mandatory purchasing network. According to a description in the Denver Post newspaper, based on a reading of the settlement agreement, Quiznos has set aside $57.5 million for franchisees who signed contracts and paid franchise fees, typically $25,000 per restaurant, but never opened their units. Known as "SNOs," or Sold-Not-Open franchises, these franchisees were unable to find a location that met with approval from Quiznos within the time period specified in their contracts, and thus lost their franchise fees under the terms of the contract. As part of the settlement, Quiznos will fund independent monitoring of its franchise sales process, which franchisees blamed for giving them unrealistic expectations of the difficulties of finding a location.

In addition, Quiznos has set aside funds to provide credits of $25,000 for franchisees who are operating today or who have not yet found a location but wish to open a franchise; the credits can be used for discounts on food or equipment purchases or debt reduction. Also, Quiznos agreed to a payment of $19.4 million to the advertising and marketing trust funds, as well as a reported $11 million in attorneys fees.

Furthermore, Quiznos will make changes to its purchasing agreements, including easing restrictions on purchasing food from suppliers outside of its network and allowing network-purchasing costs to be monitored by an independent party.

"A class action is a mechanism for fixing things and curtailing problems and issues that are perceived by the parties," said Klein. "That is what happened here."

A similar class action filed by franchisees in Canada has not been settled.

Disputes Growing Between Burger King, Franchisees

Disputes between the Burger King Corporation and its franchisees about its purchase-rebate program and menu pricing have led to a pair of class action lawsuits.

In May 2009, the Burger King National Franchisee Association ("BKNFA") filed in the U.S. District Court, Southern District of California over a plan by BK to redirect an estimated $25 million in 2010 that had been going directly to franchisees for more than a decade. The rebates are generated from Coca-Cola syrup sales in a contract under the terms of a soft-drink contract between the franchisor and the soft drink company that has been in effect since 1999. Franchisees have been receiving the rebates for use in restaurant maintenance (including purchases and upgrades soft drink equipment), but BK has proposed to redirect 40% of those rebates to the advertising trust fund that it controls.

The BK-NFA lawsuit states that the soda syrup rebates have been designated in contracts as "Restaurant Operating Funds" that are clearly directed towards individual franchise units for site maintenance. The franchisees say that the rebate program cannot be amended or ended without their agreement. The contract between Burger King and Coca-Cola will not expire until 600 million gallons of syrup have been sold to Burger King, which the lawsuit filing estimates will occur in 2022.

Another lawsuit was filed in the same court at the same time against Dr. Pepper Snapple Group, Inc., which also has a contract for sales of some of its drinks in Burger King restaurants.

Burger King filed for dismissal of the claims in late June.

BK-NFA's second lawsuit, which was filed in mid-November, challenges the franchisor's decision to offer a $1 double cheeseburger, beginning in January 2010. The lawsuit was filed in U.S. District Court, Southern District of Florida.

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As dollar-item menus have become an important part of fast-food restaurants' competitive branding in the last few years, BK has taken the position that it can require its franchisees to offer certain items at a maximum of $1, as part of the operating standards that are described its franchise contract. Franchisees disagree that the mandatory price ceiling can be imposed without their approval, and they say that the $1 double cheeseburger is a particularly egregious example because they will be forced to sell the burger at a loss.

As important as the actual profitability of the $1 cheeseburger may be, BK-NFA representatives say that the more important issue is whether franchisees have a voice in key corporate decisions that affect them. "After attempts to compromise on maximum pricing were unsuccessful, we have been forced to pursue a judicial resolution of this issue," said William Harloe, Jr., chairman of BK-NFA in a prepared statement.

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whether they wanted to buy the franchise with those restrictions.

No mention was made in *Burda* about whether a UFOC (the franchise agreements at issue were dated in 1996) was provided to the plaintiffs and, if so, whether Item 8 disclosed that Wendy's could designate itself or a subsidiary as the only supplier. It would have been interesting to know whether the franchise agreements at issue in *Burda* contained an integration clause that caused the terms of the franchise agreement to supersede the UFOC, since the court could have commented on whether actual knowledge of the restrictions trumped the less-precise terms of the franchise agreement.

In sum, in order to prevent a *Kodak* lock-in claim, drafters of franchise contracts should make sure that the possibility of the franchisor, its subsidiary, or its designee becoming the sole supplier of some or all of the products its franchisees are required to purchase is set forth clearly in the agreement, as well as being disclosed in Item 8 of its accompanying FDD.

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Franchise Disclosure

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Attorneys

Based on years of observation, attorneys are still responsible for the majority of disclosures and franchise agreements. To the uninitiated, that might appear to be perfectly logical and natural, but to those "in the know," possession of a law degree alone does not qualify one to draft quality, meaningful documents for franchise purposes. Knowledge of contract law is obviously important, but that understanding is trumped every time by franchise industry experience. A non-franchise attorney has few, if any, clues concerning the development of meaningful and functional documents (even with the benefit of crib notes and copies of competitive paperwork) because it is knowledge of the business of franchising and franchise relationships that is crucial in creating the best work. The law is only a part of quality documents; knowing what to memorialize is far more important and always will be. So, only those attorneys with proven franchise experience should be leaned on for the critical role of disclosure and franchise agreement work — and that goes to an even greater extent if the lawyer is working alone with an inexperienced franchisor, without benefit of a knowledgeable consultant to fill in the most important blanks. Someone in the mix has to know the business of franchising.

Franchisors

Seemingly more common of late, franchisors are undertaking the task of updating and registering documents themselves — and, actually, when the facts are considered, who can blame them? Most franchisors are successful entrepreneurs, not rubes in the business world. When quoted high fees for renewals and updates, they feel less reluctant to wrestle with long nights of edits; and, after studying and understanding that which they initially purchased at a dear cost, they often feel comfortable updating the documents. Emerging franchisors, after a year or two in the business, are very much aware of their segment, marketplace, competition, operational needs, and most likely, the nuances of the documents they live with daily. Although most emerging franchisors engage attorneys initially, they live with their own paperwork, and that can be as strong a factor as cost savings to motivate them to captain internal changes. Who can find fault with a new franchisor electing a do-it-yourself position when sales are slim, growth expectations are lowered, and cash is thin? (As an aside, forward-thinking attorneys might be well advised to hold new franchisors close via fees structure and relationship building.)

Of course, no logical argument can be made in support of brand-new rogue franchisors who insist on copycat launches using a competitor's paperwork and eschew consultants or any legal input. This type of new franchisor, quite often because of greed, stupidity, and arrogance, will not be deterred from his course of action, despite of the potential damage to itself and future franchisees. No law short of a moral law stops this activity.

Consultants

Finally, consultants of all description have historically involved themselves with disclosure and franchise agreement work. While it's true that a seasoned fee-for-service consultant most likely understands franchising

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U.S. Supreme Court To Hear Gasoline Dealer Case This Month

By Craig R. Tractenberg

The U.S. Supreme Court has scheduled argument on Jan. 19 in *Mac's Shell Service Inc. v. Shell Oil Products Co*. The case involves a claim by a group of gasoline retail dealers against their franchiser under the Petroleum Marketing Practices Act ("PMPA") for constructive termination and constructive non-renewal.

Some Details

The PMPA, 15 U.S.C. §§2801 et seq., regulates the circumstances in which a petroleum refiner or wholesaler can terminate a service station franchise or fail to renew a franchise relationship. In this case, several Massachusetts service station dealers claimed that they had been "constructively terminated" in violation of the Act, even though they continued to operate their franchises. Similarly, the dealers claimed that they had been "constructively non-renewed" in violation of the Act, even though they were offered and signed renewal agreements.

The case had been tried in federal court in Massachusetts. The trial judge allowed both of these claims to go to the jury, which found that all nine dealers had been both constructively terminated and constructively non-renewed.

On appeal, the First U.S. Circuit Court of Appeals reversed on the constructive non-renewal claim but affirmed the constructive termination claim. Both the dealers and Motiva Enterprises LLC (a Shell joint venture) sought *certiorari*, but, before ruling, the Supreme Court asked the solicitor general for the administration's position. The Solicitor General's Office supported granting both petitions and added that the 1st Circuit's ruling on the constructive termination claim should be reversed, and the ruling on the constructive non-renewal claim should be affirmed. The Supreme Court granted certiorari on both petitions.

Statutory Framework

Petroleum refiners and wholesalers provide motor fuel to the public through service stations that are often operated by independent dealers. A petroleum franchise agreement between the supplier and dealer typically authorizes the dealer to use a refiner's trademark, provides for the supply of fuel, and may include a lease of the premises.

In 1978, Congress passed the PMPA to regulate the franchise relationship. Congress focused on defining the rights and obligations of the parties to the franchise relationship in the crucial area of termination of a franchise or non-renewal of the franchise relationship. The Act "prohibits a franchisor from terminating a franchise during the term of the franchise agreement and from failing to renew the relationship at the expiration of the franchise term, unless the termination or nonrenewal is based upon a ground specified or described in the legislation and is executed in accordance with the notice requirements of the legislation."

The Act defines a "franchise" as a contract under which a refiner authorizes a retailer to use its trademark in selling motor fuel. The term "franchise" also includes any associated agreement providing for the "supply of motor fuel" or authorizing the retailer to "occupy leased marketing premises." Those three elements — the right to use a trademark, to occupy premises and to obtain fuel — are the statutory elements of a gasoline dealer franchise.

The PMPA provides that, except as permitted by the Act, no franchiser may: 1) "terminate any franchise prior to the conclusion of the term, or the expiration date, stated in the franchise"; or 2) "fail to renew any franchise relationship." The Act then sets forth permissible grounds for terminating a franchise during its term or declining to renew the relationship upon the franchise agreement's expiration. For example, a franchiser may terminate or refuse to renew a dealer that breaches a provision of the franchise agreement that is "reasonable and of material significance to the franchise relationship." The Act also sets forth grounds that justify non-renewal at the end of a franchise's term but not termination during its term.

The Act authorizes a dealer to maintain a civil action against a franchiser that fails to comply with the requirements of the provision restricting termination and non-renewal, subject to a one-year statute of limitations. The dealer has the burden of proving the termination of the franchise or the non-renewal of the franchise relationship; the franchiser, however, has the burden of justifying the termination or non-renewal. The Act authorizes equitable relief. Neither irreparable harm nor a likelihood of success need to be shown in order to obtain an injunction. Plaintiffs can also recover actual damages and, in any case involving "willful disregard" of the Act's requirements, punitive damages as well. Finally, plaintiffs are entitled to attorney fees and expert witness fees whenever they recover more than nominal damages.

The Dispute

The franchise agreements between Shell and each dealer specified a monthly "contract rent" for the station premises. For many years, Shell also offered a subsidy that reduced a dealer's rent depending on the volume of gasoline sold. The written program terms furnished to dealers "explicitly provided for cancellation [of that program] with thirty days' notice." The franchise agreements also contained integration clauses that required any modification to be in writing.

In 1998, Shell, Texaco and Saudi Refining combined their petroleum refining and marketing operations by forming Motiva Enterprises LLC.

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Franchise Disclosure

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business strategies, as well as critical franchise legal issues, better than an attorney without franchise expertise, attempting to handle the nuances of contracts and other legal matters is dangerous ground for even the most experienced consultant. Of even greater concern should be the handling of legal work by those "brokers" and sales-focused consultants who offer Franchise Disclosure Document development as part of their overall plan to assume the franchise sales or marketing role with new franchisors. In these cases, the primary objective of the "consultant" is to carve out a profit position as adviser, salesperson, and franchise expert within organizations that otherwise have little or no franchise experience. However, even in the case of fee-for-service consulting and mentoring engagements where the consultant has experience, knowledge, and history of dealing with legal documents, it is most foolish to diminish the role of a competent franchise attorney in the overall scheme of quality development. There are simply too many legal details and changes in the law that can be overlooked.

The Best Scenario

The very best scenario is, as with all things worth doing well, a combination of expertise covering all important issues. Very simply, in terms of new, emerging, and advanced franchisors, the best team (and the best chances for franchisor success) result from three elements: 1) a concept and a management team that meet the criteria for franchise feasibility; 2) mentoring, education, and strategic input from a proven consultant; and 3) the balance struck via participation and legal oversight provided by a knowledgeable franchise attorney. Anything short of that approach is a shot in the dark, for both franchisor and any potential franchisee investor.

Conclusion

Although it is not common thinking, in fact, the most important tool in a franchisor's kit will always be its disclosure documents and agreements, if they are properly conceived and prepared as a memorial to the key attributes of a given franchise. To achieve that end, only the coordinated efforts of a professional team should be considered.

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Gasoline

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Because the entities forming Motiva had offered different terms to their respective dealers, Motiva inherited franchise agreements with inconsistent provisions. In addition, unlike Shell, Texaco had not offered a volume-based rent subsidy.

Motiva took two steps that reconciled those differences that led to the disputes in this case. First, invoking the provision authorizing it to discontinue the volume-based rent subsidy, Motiva substituted a transitional subsidy for 16 months, and then ended the subsidy entirely, effective Jan. 1, 2000. Second, as each dealer's franchise agreement expired, Motiva offered a new agreement that calculated annual rent using an asset-based formula similar to the one Texaco had used: 10% of the value of the land, plus 12% of the value of the buildings, plus 12% of the value of the equipment. The Texaco formula reflected a change in the use of gas stations from simply selling gasoline and oil to including also convenience stores and other amenities.

Motiva's attempt to standardize its franchise system resulted in subsidy and rent changes to the dealers. The dealers sued under the PMPA for constructive termination and constructive nonrenewal.

The dealers prevailed at trial by arguing that Motiva drove them out of business without formally non-renewing or terminating them. Motiva argued that unless it had deprived the dealers of one of the three elements of a PMPA franchise, there is no claim under the statute, even if a dealer does go out of business. Motiva argued that a service station dealer that continues as a franchisee, receiving all three elements of its franchise trademark, lease, and fuel, was not "terminated" within the meaning of the Act. Likewise, the franchiser argued that a dealer that is offered and executes a renewal agreement cannot claim that the franchiser "failed to renew" the relationship.

Conclusion

The issues of constructive termination and non-renewal may have importance beyond the PMPA and may affect other franchise, intellectual property licenses, and real estate litigation. We all await this rare argument on franchise law issues.

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AAA Reduces Fees

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that there aren't excellent arbitrators out there."

Yet, arbitration surely has a role in resolving franchise disputes, regardless of whether the new fee structure proves to be popular. "Franchising is a relationship business in which the parties intend to continue to work together after their issues are resolved," said Johnson. "Arbitration and mediation work very well in those situations."

Conclusion

The pilot fee program will be offered through May 30, 2010, and it is one of several innovations recently developed or in the process of being developed by AAA. In 2009, AAA began to offer non-binding arbitration. In first-quarter 2010, it will roll out a program in which retired judges will provide judicial settlement services that Johnson said would be similar to mediation but with procedures closer to those of a courtroom.

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