Some Thoughts on Settling Franchise Disputes

EDWARD WOOD DUNHAM

Edward Wood Dunham

The rituals of contemporary civil litigation usually do not culminate in a judge crafting a carefully reasoned opinion after a bench trial or a foreperson announcing the result of a jury's thoughtful deliberations. The typical last rite is the exchange of releases and a settlement check. Sometimes this happens soon after suit is filed, more often only after the parties have slogged through expensive discovery and inconclusive motion practice, and sometimes settlement cannot be reached until trial is underway. But the anticipated denouement, sooner or later, is almost always settlement. On the increasingly rare occasions when parties invoke their constitutional right to try a case to conclusion, many judges and litigators would posit as the only plausible explanation that "someone was being unreasonable."

The true objective of most civil litigation today is no longer winning at trial, but optimizing bargaining leverage in the virtually inevitable, frequently judge-required, settlement negotiation.[1] Accomplishing that goal in a franchise dispute (as in every other type of case) requires, first and foremost, a realistic appraisal of the facts and the applicable law. However, unless the parties and their counsel also understand the other factors that influence whether and on what terms franchise cases settle, their bargaining approaches and outcomes are likely to be suboptimal. In my view, seven factors must always be taken into account.

1. How Will the Settlement Terms Read in the UFOC and Influence Other Franchisees?

Sensible franchisors are always concerned about the potential multiplication of claims. The larger the system, the greater the universe of potential plaintiffs, and the bigger the risk that the outcome of one case will prompt more of the same. This fact may cause some franchisors to settle, for fear that a big damage award could unleash a flood of copycat claims. Certain large franchisors, however, may worry that if franchisees conclude that a lawsuit or arbitration is the road to "easy money," a traffic jam will ensue, jeopardizing system discipline and the franchisor's economic well-being. This can produce an entirely different risk management approach, as franchisors decide to take more cases to term and risk losing rather than paying "too much" to settle with too many franchisees, on the theory that a hard line will reduce the settlement value of individual claims and, over time, reduce the volume of claims.

This concern about adverse settlement "precedent" would exist in any event, because every franchise system has a grapevine (if not an official organization) by which franchisees communicate with each other. In other types of commercial disputes, strict confidentiality requirements in settlement agreements may keep the terms under wraps. But settlement agreement confidentiality clauses have limited utility for franchisors, unless a settlement occurs before any suit or arbitration has been filed, because of their disclosure obligations under the FTC Franchise Rule and the Uniform Franchise Offering Circular (UFOC) Guidelines. Every settlement of a significant franchisee claim appears in the franchisor's disclosure document for ten years, and no prudent franchisor can ignore the potential effect on existing franchisees, prospects, and plaintiffs' lawyers of a settlement pattern that these audiences might treat as an invitation to sue.

This is sometimes the franchisor's central consideration, and can be an insuperable obstacle to settlement. It therefore behooves franchisees, their counsel, and neutrals involved in negotiations to take this concern seriously and try to identify creative (but lawful) ways to minimize the disclosure impact of settlements.

2. The Forum and Decision Maker(s)

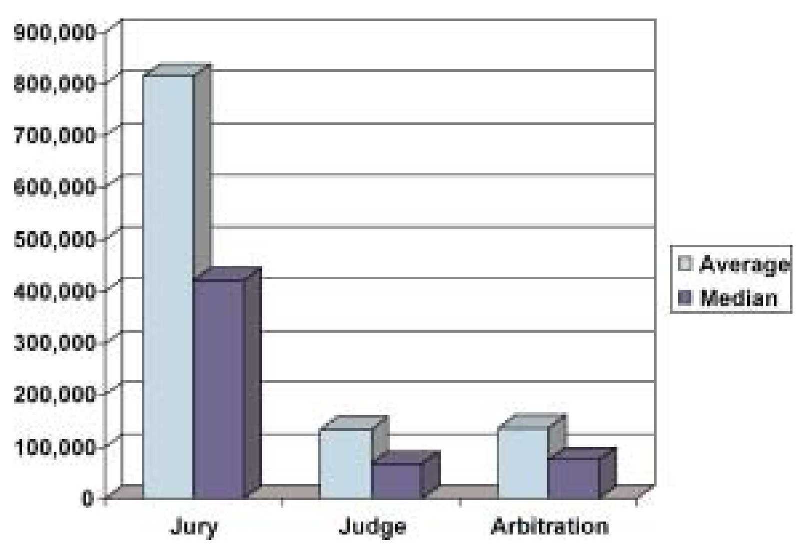
If the case does not settle, where and before whom will it be tried? If the franchisee must travel to the franchisor's home court, pursuant to a forum selection clause that has been or is likely to be enforced, there are both economic and psychological consequences. If the franchisee must instead arbitrate, that also has implications for settlement. First, the transactional costs can sometimes be higher in arbitration than in litigation.[2] Second, while arbitrators may well find for the franchisee, they are generally, and probably accurately, perceived as less likely than jurors to issue staggering damage awards. In addition, while the loss of a bench or jury trial can sometimes have adverse peripheral consequences for the franchisor because

Edward Wood Dunham is the Editor-in-Chief of the Franchise Law Journal. This column, which expresses his personal opinions and does not reflect the viewpoint of the ABA's Forum on Franchising or the Franchise Law Journal, is adapted from material that he wrote for a program on "Litigotiation" that he presented with David M. Geronemus at the 25th ABA Forum on Franchising. Mr. Dunham thanks Mr. Geronemus for his thoughtful editorial comments, which are reflected in this column.

other franchisees can rely on the decision under the doctrine of collateral estoppel, it may be more difficult for franchisees successfully to assert the preclusive effect of an arbitration award. Because arbitration awards can be cryptic one-liners, and there may be no accurate record of the proceedings, it may be difficult to reconstruct what was actually at issue and decided. Also, arbitrators in later cases may not be required by law to give preclusive effect to the award, or may simply choose not to be bound by it, with no risk of reversal on appeal.

On the other hand, arbitration can also have some real attractions for franchisees. In litigation, well-heeled defendants sometimes have the opportunity to wear down less affluent plaintiffs with onerous discovery; whether the plaintiff or its counsel feels the economic effect of that, and perhaps an attendant desire to settle, may depend on the fee arrangement. This potential leverage is usually absent from arbitration, since discovery is typically so minimal. In most arbitrations, moreover, neither substantive law nor the rules of evidence play the same role that they do in court. Many arbitrators see their job as "doing equity"—fashioning what they envision as the fairest possible result, irrespective of what strict application of the law would yield—and give short shrift, if any, to evidentiary niceties. Thus, in arbitration the chances of defeating a claim by motion, or driving down settlement value by successfully challenging a damage expert's proposed testimony, are slight. Further, if the franchisor loses the arbitration, in all probability it is stuck with the result, because most courts routinely rubber stamp arbitration awards pursuant to enormously deferential standards of review.

If the franchisor is facing a jury trial, especially in the franchisee's home forum, the settlement dynamics are very different. Every jury is a wild card, particularly if the franchisee has a plausible basis for a big damage claim. Based upon a study of UFOC Item 3 disclosures that I supervised in connection with a program at the 2002 ABA Forum on Franchising,[3] the average and median jury verdicts against franchisors were dramatically higher than the damage awards that judges and arbitrators issued against franchisors:



The skyscraper on the left in this chart is something that any franchisor facing a jury trial would do well to keep in mind.

3. The Roles of Motion Practice and Appeals

In settlement negotiations, defendants often tout the strengths of their legal position. Every plaintiff's lawyer, settlement judge, and mediator have heard countless defense attorneys express confidence about winning a summary judgment motion and, if all else fails, prevailing on appeal. That confidence can prove well placed in a given case, and overall statistics may, of course, foretell nothing about the likely outcome in a specific dispute. Those statistics show, however, that in the civil justice system as a whole and in narrower case categories, winning either a dispositive motion or an appellate reversal of a plaintiff's jury or bench trial victory is unlikely.

In the aforementioned survey for the ABA Forum on Franchising, for example, only 16 percent of the concluded cases terminated by motion, and in state court actions the figure was just 12 percent.[4] Data on state appellate court reversal rates are not readily available, but the federal circuit courts affirm in a clear majority of appeals. For the twelve months ending September 30, 2001, only 9.5 percent of judgments in private civil appeals were reversed, ranging from a low of 1.8 percent in the Second Circuit to a high of 16.7 percent in the Seventh Circuit.[5] Because these figures reflect the results of every appeal of every appealable ruling, judgment, or verdict, however, they probably overstate the odds against a defendant's success in challenging a plaintiff's trial victory.

In a recent study, two Cornell law professors closely examined a database of all federal civil trials and appeals decided from fiscal year 1988 through fiscal year 1997.[6] They looked at thirteen case categories,[7] including general contract and fraud, and calculated appeal and reversal rates on appeals from both bench and jury trials. They found that only about 21 percent of trial outcomes were appealed, and that in only 21 percent of those appeals did the circuit court reverse.[8] Several other conclusions from this study are also notable, and perhaps germane to settlement calculations. First, "none of the prior opinion on jury sacrosanctity prove[d] correct,"[9] since jury and bench trials were appealed and reversed at the same rates.[10] Second, there was a marked difference in the reversal rates in jury verdict appeals by defendants and plaintiffs. Defendants appealing "plaintiff trial wins" obtained a reversal 31.14 percent of the time, while plaintiffs challenging "defendant trial wins" got reversals in only 13.18 percent of the cases.[11] In the two case categories most likely to include franchise disputes, general contract and fraud, these were the reversal rates (aggregated for jury and judge trials):

	Overall Reversal Rate	Defendants' Appeals	Plaintiffs' Appeals
General Contract	23.42	25.85	20.25
Fraud	33.33	41.38	24.00*

*Kevin M. Clermont and Theodore Eisenberg, *Appeal from Jury or Judge Trial: Defendants' Advantage*, 3 AM. LAW & ECON. REV. 125, 137 (2001).

In short, although the prospects for a successful appeal are, at least in federal court, far from hopeless, any party trying to overturn a jury verdict or bench trial decision will always be traveling statistically uphill.

4. Is There a Continuing Business Relationship and Do the Parties Want to Salvage It?

If a franchisee has already been terminated and damages are the only relief it seeks, that can affect settlement potential in diametrically opposite ways. On the one hand, the franchisee may be in economic straits and ready to make a deal. But the franchisee also may be angry and eager to exact retribution, and that emotional overlay can harden if it does not carry any economic cost (i.e., if the franchisee's lawyer is working on a contingency).

If termination is a possible outcome of the dispute, and the franchisee wants to preserve the relationship and its livelihood, that can be a strong incentive to settle. No matter how bullish the franchisee's lawyer professes to be about the likely outcome, the franchisee may not have the stomach for learning whether its counsel is right. Also, whenever the franchisee is still in the system, that may create a possibility for settlement on terms more creative than simply the payment of money in exchange for a release. If the franchisee wants to exit the system, the sale of its business (including ownership or leasehold interest in any building and real property) to the franchisor, or to another franchisee or third party in a transaction facilitated by the franchisor, can sometimes make settlement far easier to achieve. The franchisor may be better able than the franchisee to identify an acceptable buyer, and this settlement approach may also be more palatable to the franchisor because of how it will read in the UFOC.

In disputes with franchisees who want to remain in the system, franchisors amenable to that outcome may be able to make adjustments in the relationship as the basis for settlement. If, for instance, the franchisee is complaining of encroachment, the franchisor might be able to resolve the dispute by helping the franchisee acquire and fit out an additional unit, via a reduced franchise fee and/or a low-interest loan. That outcome, giving both franchisor and franchisee the prospect of increased income, will often make a lot more sense than funding a lawyers' battle that will, in all probability, leave the parties with a damaged relationship.

5. The Status of the Franchisor and Its System

As discussed above, certain franchisors take a hard line on settlement, but that is a luxury not all franchisors can afford, either literally or figuratively. If the system is still at an early stage of development, litigation of any significance can divert management attention and financial resources from growing and improving the system, and, depending on the issues, management may fear that an adverse outcome (or the existence of unhappy, vocal franchisees, discouraging prospects) will make it difficult to sell new franchises.

Even for more established systems, undergoing the economic and psychological drain of full-blown litigation is sometimes not advisable, especially if the subject matter of the case has system-wide implications.

6. The Characteristics of Counsel

In many relatively straightforward disputes, the quality of counsel may have no impact on settlement value. Often, however, the experience, skill, and risk tolerance of the lawyers, and the client's perceptions of those characteristics of its own and its adversary's attorney, may play a significant part in determining value. A few questions help make the point:

- Do the lawyers actually try cases, or are they big talkers who always settle?
- If the case is going to a jury, have the lawyers ever been there before?
- Do they understand franchising, or are they generalists with a flimsy grasp of the business realities?
- Are they demonstrating a command of the facts and the stamina to stay the course, or are they disorganized and seeming eager to make a deal?
- Are they being paid by the hour, which may create an incentive to "churn," or working on a contingency, which may create an incentive to "dump" a case if it is time consuming, expensive to prepare, and blemished on either liability or damages?
- Given the facts of the case and the intellects and personalities of your witnesses, does opposing counsel have the capacity to hurt them on cross-examination? Has counsel already proved that, and influenced settlement value, by extracting damaging concessions during depositions?

Mediocre lawyers sometimes win big verdicts and hold them on appeal, and the excellence of counsel can only do so much to overcome bad facts, ineffective witnesses, or adverse precedent. But in settlement negotiations, each client's perceptions of its own attorneys and its adversary's lawyers can be an important ingredient in assessing exposure and thus determining settlement value.

7. The Emotional Constitutions of the Participants

Business executives like to see and present themselves as creatures of objective reason, unswayed by emotion. That is frequently an inaccurate picture. Even in disputes between sophisticated entities, emotions—personal animus, fear of blame, ego-driven brinksmanship—often derail settlements. Helping a client transcend these emotional entanglements, and properly navigating the other side's emotional currents, are among the lawyer's most important and difficult tasks in settlement negotiations.

Moreover, some people are just not built for strain. Others thrive on conflict. There are litigators, corporate CEOs, franchisees, and important witnesses in each camp. Since strain and conflict are the daily bread of every significant lawsuit and arbitration, a meaningful assessment of settlement—how hard to push what the other side's walkaway position really is—always requires a clear-eyed appraisal of the emotional constitutions of the principal participants on each side of the case, including self-analysis by the person with settlement authority and the lawyer who will try the case if it does not settle.

Endnotes

1. Smart litigators understand, however, that in most cases the best way to strengthen settlement position is to prepare the case skillfully for trial, and to communicate to the other side that the client and the lawyer are ready, willing, and able to stay the course, if necessary.

2. Lawyers for franchisees have contested arbitration on the theory that these extra costs make the arbitration clause unconscionable. These challenges almost always fail. *E.g., Doctor's Associates, Inc. (DAI) v. Hamilton,* 150 F.3d 157, 163 (2d Cir. 1998), *cert. denied,* 119 S. Ct. 867 (1999). Mr. Dunham represented DAI in that case.

3. We looked at the UFOC Item 3s of thirty leading systems, including the ten that *Franchise Times* magazine ranked as largest in number of units. Other results of this survey are reported in *Franchise "Litigotiation": Understanding the Interplay of Litigation/Arbitration Outcomes and Settlement Negotiation in the Resolution of Franchise Disputes,* Edward Wood Dunham and David M. Geronemus, ABA 25TH ANNUAL FORUM ON FRANCHISING (2002), Workshop 2, pp. 1–29.

4. *Id.* at 27

5. *Judicial Business of the United States Courts,* 2001 ANN. REP. OF THE DIRECTOR, Table B-5, pp. 98–101.

6. Kevin M. Clermont and Theodore Eisenberg, *Appeal from Jury or Judge Trial: Defendants' Advantage,* 3 AM. LAW AND ECON. REV. 125, 137 (2001).

7. *Id.* at 128.

8. *Id.* at 130.

9. *Id.*

10. *Id.*

11. *Id.* at 131.