Hamilton Pratt Article

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Who would be a Franchisor?

The theme of this article is that the litigation tide is moving away from franchisors and that currently litigation is the biggest risk for franchisors in the UK. The article seeks to set out why that may be so.

There is an inherent conflict in franchising. At the beginning of the franchise relationship the franchisor provides a great deal of assistance, information, guidance and other elements to an incoming franchisee for which it receives very little financial return. Franchisees pay an initial fee but the initial fee usually covers the franchisor's costs and does not contain a profit element or a substantial profit element. The continuing fees which do contain a profit element for the franchisor, are usually very low at the early stages of a franchisee's business. Subsequently, when the franchise is fully operational and has established a client base, franchisees make much less use of a franchisor because they are, by that stage, experienced and yet, at that stage, they have to pay substantial continuing fees. This inevitably causes tensions.

Further, franchise agreements are, by their nature, long term agreements which are lengthy and complex and are entered into by a large number of franchisees. Simply on the law of averages you would expect there to be a dispute with some of those franchisees. The final "ingredient" to add to the mix is the cost of litigation in the UK. Hamilton Pratt recently undertook a survey asking franchise lawyers in a number of jurisdictions to indicate the likely costs of litigation in respect of a notional case involving a dispute between a franchisor and a franchisee that would involve a court hearing lasting two days. The costs of litigation in the UK were higher than in any other jurisdiction – including the US - and if you add the fact that the losing party in English proceedings has to pay a substantial percentage of the winning party's costs of litigation – which generally is not the case in the US – then litigation in the UK is substantially more expensive than the US and other jurisdictions.

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Nigel Boardman, a senior partner at Slaughter and May, in an article in the Financial Times recently, indicated that Britain's legal system was Dickensian and there was a real risk that litigation was reverting to the situation in Dickens' novel Bleak House where in the fictional case of Jarndyce v Jarndyce, generations of the Jarndyce family sought to settle a family dispute concerning the inheritance of a family estate through the courts only to use up all of the family's assets in the process. In this context Mr Boardman referred to a recent case involving the Russian oligarch, Mr Berezovsky who sued Roman Abramovich, lost and had to pay £35 million towards Mr Abramovich's legal costs. In that case there were 50 solicitors including 22 partners and 32 barristers including 8 QCs! Mr Boardman made two recommendations. The first is that English litigation should move away from oral hearings which were only adopted at a time when the majority of the population could not read or write and which was now – using the words that only a lawyer could use – "merely an expensive and otiose theatre". His second recommendation was to limit disclosure so that it simply required the parties to disclose documents on which they are relying and not all documents that could be relevant to the case – for many franchisors involved in litigation this is a huge burden especially in the age of largely electronic communication.

In terms of the practical steps that franchisors should take to reduce the risk of litigation, they are:

- Risk analysis – franchisors need to undertake a detailed risk analysis establishing what are the risks to their business, what could be done to minimise those risks and what would happen if those risks were to prevail. Franchisors currently do not recognise the litigation risk and therefore do not seek to minimise it or to plan for it. This needs to change.
- Reserve – because of the almost inevitability of franchise disputes and litigation, it would be sensible for franchisors to reserve for such an eventuality/create a fighting fund. That is not the same thing as encouraging franchisors to litigate but without the wherewithal to litigate should the need arise – as it almost certainly will – franchisors immediately are putting themselves in a weak position.
- Insurance – franchisors do need to investigate legal expenses insurance and not simply after the event insurance. That having been said there are very few policies which provide for franchise disputes because underwriters take the view that the outcome of such disputes is uncertain and disputes are inherently likely to arise – precisely why franchisors would want insurance!
- Conditional fees – very often franchisees are represented by lawyers acting on a conditional fee arrangement. In the circumstances it is difficult to justify franchisor lawyers refusing to do so and franchisors do need to investigate whether their lawyers would be prepared to back their assessment of the merits of a case by proceeding on a conditional fee basis.

What factors suggest that the litigation tide is moving away from franchisors? They are:-

- Until five years ago, franchise lawyers tended to represent franchisors rather than franchisees and franchisees would generally obtain their advice from solicitors who were unlikely to have a detailed knowledge of franchising. This put franchisors at a substantial advantage. That has now changed. There are a number of firms specialising in representing franchisees and which offer specialist franchise advice.
- Even though the UK does not currently allow class actions franchisees may act as a group. The franchisee bar recognises that it is very much in its commercial interests to represent a large number of franchisees rather than individual franchisees and so group action is encouraged. A group of franchisees may be able to fund litigation which would be beyond the means of an individual.
- Competition law is likely to have an increasing importance in franchising. The relatively recent decision of the High Court in which Pirtek sought to enforce post termination non compete covenants against an ex franchisee demonstrated a franchisee's willingness to raise complex competition law issues. Franchisors can now expect to have to deal with these issues when seeking to enforce post termination non compete covenants. In addition, the government has indicated that it is considering introducing class actions in relation to competition law disputes under which parties would have to "opt out" of a class rather than "opt in". This will make it much easier for franchisee lawyers to create a group of franchisees for the purposes of litigation. There is plenty of scope for competition law issues to arise in a franchising context. For instance, at a recent European Franchise Federation legal committee the group of national experts highlighted no less than sixteen areas where the competition law aspects relating to the use of the internet were unclear and where as a result franchise disputes could thrive.
- The judicial approach, perhaps reflecting the approach of the courts within Europe, is increasingly to do "justice" and to apply a less formalistic and rigid approach to the interpretation of contracts and establishing the rights and obligations of the contracting parties. This approach is seen, in particular, in the Queen's Bench Division of High Court. Unfortunately, judges may not fully understand the commercial realities of franchising and therefore fail to appreciate why franchise agreements have to be so onerous in terms of regulating franchisees' activities. With that lack of understanding Judges, very understandably, succumb to the notion that the all powerful franchisor is able to impose its will on hapless franchisees who need judicial protection!

- One area where franchisors previously had the upper hand was in relation to injunctions. In order to put themselves in a position to obtain an injunction franchisors merely have to persuade a judge that there is a serious issue to be tried and not necessarily that they would win at trial. For many lawyers representing franchisees the bar is set too low thereby making it relatively easy for franchisors to obtain injunctions. What made matters worse – for franchisees - is that in Dairy Crest v Piggot the court seemed to indicate that defendants in an injunction application should offer undertakings to proceed to a speedy trial rather than argue against the injunction. In such a scenario franchisors historically have known that an injunction application is almost always going to lead to an award of either an injunction or an order from the court to move to a speedy trial – a trial which a franchisee may simply not have the wherewithal to defend. This pro claimant approach may be changing. The decision in Scott v Scott (Lawtel 08/10/12) shows that the position of the defendant is not quite as weak as was once thought. In that case the claimant sought to enforce covenants in a partnership deed and successfully argued that there was a serious issue to be tried. Nevertheless the Judge refused to grant an injunction because when striking the balance of convenience the court took into account the claimant's delay, issues about whether full disclosure had been made and concerns about the value of the claimant's cross undertaking as to damages (a "guarantee" from the person seeking an injunction that it would be good for any damages payable to the defendant if the Claimant, after obtaining an injunction lost at the trial) and the impact that the injunction would have on the defendant who would not have been able to undertake any work at all. Whilst the case does not create any new law it is certainly instructive and no doubt franchisees' lawyers will review the case carefully. Further, in another recent case Speedier Logistics Co Limited v Aardvark Digital Limited (LTL 49 2012) Mr Justice Eader reminded lawyers that the duty of full and frank disclosure operated whether or not the application was made with or without notice. Fulfilling this duty can impose very considerable burdens on a franchisor seeking an injunction.

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The "high level" trends have been set out above. Let us turn next to the lessons that can be learnt from analysing a specific recent decision – Papa Johns (GB) Limited v Elsada Doyley. On the face of it this was a straight forward action commenced by the franchisor, Papa Johns, to recover sums due to them by a franchisee that had abandoned the franchise because she had been unable to make a financial success of it. With a degree of inevitability, the ex franchisee went to see a lawyer who raised issues of misrepresentation in relation to the figures provided by Papa Johns to Ms Doyley to encourage her to enter into the franchise agreement. On the face of it, Ms Doyley's position was not a strong one because:

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- Notwithstanding the fact that Papa Johns had urged Ms Doyley to obtain legal advice she chose not to – apparently on the basis that there was no point because the franchise agreement was non negotiable.
- The franchisor had provided a full list of its franchisees and yet Ms Doyley decided not to contact any of them.
- Ms Doyley failed to undertake any due diligence other than, curiously, contacting Domino's Pizza to obtain information about their franchisees' figures.
- Ms Doyley never complained that she had been misled by Papa Johns in relation to the figures that they had provided up until the time of her counterclaim when proceedings were brought by Papa Johns.
- There was confirmation from Ms Doyley's accountants that her financial performance was in line with the figures provided by Papa Johns.

- Ms Doyley had prepared her own business plan which had not been prepared by Papa Johns although it had been submitted to Papa Johns who, unfortunately, simply ignored it.
- Ms Doyley did not follow the Papa Johns business model which is essentially a take-away food business. Instead she incorporated tables and seating at her outlet. She was keen to create a casual leisure dining experience although this was against the advice of Papa Johns.

Yet notwithstanding the above, Ms Doyley was successful. What are the "top ten" tips from the Papa John's decision and generally from franchise litigation. They are:

1. Be very careful in your choice of defendant. Ms Doyley was a deeply religious tea total ex nurse who at the time of entering into the franchise with Papa Johns was caring for children with learning difficulties. She had no knowledge of franchising, the fast food business or indeed, of business. In the circumstances it was entirely to be predicted that she would have the sympathy of the court.
2. Do you really have to sue? Whilst it is galling for any franchisor not to pursue a franchisee who clearly owes the franchisor substantial sums, franchisors have to take action with their eyes open and in the knowledge that it is likely that the franchisee will counterclaim and, further, it is likely that that counterclaim will involve a claim of misrepresentation which is difficult and complex to deal with so that what starts out as a very simple debt recovery action turns into complex and enormously expensive litigation.
3. It used to be said that it is necessary for a franchisor on occasions to send an appropriate message out to the network. As one observer has pointed out "if you think you have to send a message it means that you have not been communicating with your franchisees". In any event franchisees are sufficiently sophisticated to know that decisions depend on facts and their facts may not be the same, so the "message" may be of limited relevance. Further, there is a substantial risk that if the court does not agree with the franchisor that precisely the "wrong" message is sent to the network!

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4. Franchisors are becoming increasingly sophisticated with the materials and information that they provide to prospective franchisees. Franchisors produce glossy disclosure, web sales, videos, prospectuses and other documents all of which are prepared by the franchisor's marketing department with a view to recruiting franchisees and are very rarely reviewed by lawyers. They are even more rarely updated on a regular basis whether by lawyers or others in the franchisor's management to ensure that the information contained in these documents continue to be accurate. In a number of cases Judges have put very considerable emphasis on the claims set out in these documents which generally seek to reassure prospective franchisees of the franchisor's experience and that franchisees can rely on that experience and what franchisors tell them. In other words they can create a duty of care or at least encourage the creation of such a duty.
5. It used to be said that the franchise agreement after it is executed should be put away in a draw and nobody should bother about it. The opposite is in fact true. Members of staff at franchisor organisations who have a franchisee facing roles need to be very much aware of what is in the franchise agreements, ensure that the franchisor knows what franchisees have agreed to do!

6. The really crucial passage in the Papa Johns case were the first two sentences of paragraph 184 of the judgment in which the Judge said: "it would be reasonable to assume, in any event, that PJ's knew the levels of sales it franchisees were achieving. Without such knowledge they could not have run their business successfully …". Judges will proceed on the basis that franchisors have actual franchisee performance figures and it will be very difficult to persuade a Judge that that was not the case and if it is the case that prospective franchisees did not need to be provided with figures based on actual average performance. Further, of course, if franchisors have actual franchisee performance figures but provide different figures, it may be challenging for franchisors to argue that their misrepresentation was not fraudulent.

7. The whole area of business plans is fraught with difficulty. Clearly the franchise units of the banks do encourage or at least welcome the active involvement of franchisors in the preparation of a business plan because this gives the banks reassurance that a franchisor is comfortable with the business plan. In fact, from a legal perspective all that franchisors should do is to provide raw data based on actual average performance and then leave the preparation of the business plan, including cashflow forecasts, and projections to the prospective franchisee. Further, systems should be in place to ensure that if a prospective franchisee submits a copy of a business plan that it is not simply ignored (as was the case in the Papa Johns decision) and that the prospective franchisee is informed that the franchisor does not review or endorse the franchisees' business plans.

Whilst franchisors should not under any circumstances be prepared to change the commercial terms, franchisors do need to consider whether they should signal, without changing those commercial terms, that they would be prepared to consider changes in drafting if prospective franchisees have a problem with the drafting.

8. It is a cardinal principal of franchising – that franchise agreements are non negotiable. Franchisors are encouraged to say to prospective franchisees "we would love you to be our franchisee but it has to be on the terms of our standard form franchise agreement which we will not alter". Clearly under both unfair contract terms legislation and also in relation to how a Judge views a franchise agreement, the fact that it is a standard form non negotiable document is unhelpful. Whilst franchisors should not under any circumstances be prepared to change the commercial terms, franchisors do need to consider whether they should signal, without changing those commercial terms, that they would be prepared to consider changes in drafting if prospective franchisees have a problem with the drafting.

9. Lawyers, for obvious reasons, over play their importance in terms of their drafting expertise and, therefore, tend to overplay the role of disclaimers and other clauses which seek to limit franchisor's liability to franchisees. Franchise lawyers do not do their clients any service in adopting this approach. Instead franchise lawyers should emphasise the limit of such clauses. They are helpful but only at the margins, and in practice are most unlikely to be effective to protect franchisors from a misrepresentation claim. Until franchisors understand and accept this they may not embrace full and accurate disclosure based on actual average performance.

10. Lastly, it appears that the Queen's Bench Division of the High Court may be more favourable towards franchisees than the Chancery Division. Consideration needs to be given as to which division of the High Court a franchisor pursues a claim.

John Pratt
Partner
Hamilton Pratt

Hamilton Pratt
Franchise House
3A Tournament Court
Tournament Fields
Warwick
CV34 6LG

Tel: 01926 838 900
Fax: 01926 258 799