WHEN IS A TERMINATION RIGHT NOT REALLY A TERMINATION RIGHT?

Joshua Stein[1]

If a contract says that either party can terminate that contract at any time for any reason or no reason, can either party terminate the contract at any time for any reason or no reason?

Not necessarily.

A recent New Jersey Supreme Court case may mean – and was interpreted in the last issue of "The Innkeeper" as meaning – that even when a party (the "Terminator") has an absolute right to terminate a contract on 90 days notice, the courts can look behind the Terminator's decision to terminate.

The courts can examine the circumstances of the termination. They can look at the Terminator's behavior before termination. They can evaluate whether, in terminating the contract, the Terminator acted consistently with the "implied covenant of good faith and fair dealing." This is an analysis that can go far beyond mere old-fashioned "breach of contract."

If a court decides the Terminator acted out of impure motives, or behaved badly in performing the contract even before termination, the Terminator may incur liability by terminating. This is true even if the Terminator complied to the letter with the express terms of the termination right. And it's true even though under established law the mere exercise of a contractual termination right supposedly can't create liability.

The recent New Jersey case, *Sons of Thunder, Inc. v. Borden, Inc.*,[2] was celebrated in the last issue of "The Innkeeper" as a great victory for hotel managers and a reason why all hotel managers should want New Jersey law to govern their management agreements.

It was suggested, for example, that the *Sons of Thunder* case might help hotel managers protect themselves against hotel owners who might exercise a contractual termination right merely so they can reflag their property or find a cheaper manager.[3]

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[2] 148 N.J. 396, 690 A.2d 575, 1997 N.J. Lexis 79 (1997).

[3] The owner would, of course, have thought it had negotiated an absolute termination right precisely to facilitate such a move if market conditions later warranted it. Why else would the owner have negotiated such a termination right? And what one person calls "greed" another might call an intelligent business decision in a competitive market – or just another example of the "perennial gale of creative destruction" of the capitalist free enterprise system. *See* Joseph A. Schumpeter, *Capitalism, Socialism and Democracy* 84.

The holding in *Sons of Thunder* was really not as simple and straightforward as described above. Parts of the case do suggest, though, that, under some circumstances, exercise of a contractual termination right in accordance with its terms can create or increase liability – particularly if the Terminator was less than enthusiastic in performing the contract before termination.

In the *Sons of Thunder* opinion, the New Jersey Supreme Court repeatedly said that when a party exercises an express termination right in accordance with its terms, such termination cannot, in and of itself, breach the implied covenant of good faith and fair dealing. The court made this point so many times one might ask whether the court really meant it.[4] This question is particularly appropriate given that the court did seem to attach some weight to the termination, as part of the larger picture, in deciding that a jury could find the Terminator had breached its implied covenant of good faith and fair dealing.

In an article in the last issue of "The Innkeeper,"[5] Richard W. Barrett and James S. Renard emphasized their view that *Sons of Thunder* means a party to a contract can incur liability for the mere exercise of a contractual termination right, in accordance with its terms.

Barrett and Renard saw this as good news for any party to a contract, particularly a hotel manager, who may be the victim of a contractual termination that is "in bad faith or for an ulterior motive." In their view, *Sons of Thunder* suggests that "the evolving concept of implied contractual duties may come to the rescue" of that victim, and let the victim recover damages for a bad faith termination, even a termination done "as of right."

To the extent that this interpretation is correct – i.e., to the extent that *Sons of Thunder* suggests a cause of action for "bad faith" termination of a contract in accordance with its terms – the writer believes that *Sons of Thunder* represents the beginning, or perhaps the continuation, of a trend that ultimately will not serve well anyone in the business world.

In the opinion of the writer, *Sons of Thunder*, as interpreted in the last issue of "The Innkeeper," represents yet another defeat for predictability and simplicity in commercial contracts. On a macro level, that trend does not benefit hotel managers, hotel owners, or anyone else that benefits from knowing they can negotiate and enter into contracts and expect those contracts to be enforced as written.

In *Sons of Thunder*, a multinational conglomerate ("Goliath") agreed to buy a minimum volume of a product from a small businessperson ("David") for five years.[6] Each party reserved the right to terminate at any time on 90 days notice. David had no lawyer.

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[4] *Compare* W. Shakespeare, *Hamlet*, Act III, Scene 2, lines 230-235 ("The lady doth protest too much, methinks."), reprinted at http://www.engl.uvic.ca/Faculty/MBHomePage/ISShakespeare/Ham/ Ham3.2.html.

[5] The Innkeeper, Volume 1, Issue 1, April 1999, pg. 5, reprinted from *Lodging Hospitality*, January 1998, page 45.

[6] The choices of defined terms are, of course, deliberate. They may explain everything.

David invested heavily in reliance on a relationship that David thought was a sure thing for five years. In hindsight, David was overoptimistic. In hindsight, he invested more than he should have. Much of it was borrowed. Much of the equipment he bought had no alternative uses. Goliath encouraged this overinvestment every step of the way.

For a while, Goliath performed as agreed. Everything was wonderful, more or less.

Goliath eventually became less enthusiastic about David. Greedy Goliath figured out cheaper ways to buy David's product. In one of its many corporate acquisitions, Goliath bought a company that produced the same product, probably at lower cost. Long before Goliath actually terminated David's contract, Goliath chronically purchased less than the contractual minimum.

When Goliath replaced the management team that had dealt with David, the new managers told David repeatedly that they didn't want to honor his contract. Eventually, the new management formally terminated it, in strict compliance with its terms.

David claimed and recovered damages for breach of contract for Goliath's failure to make the minimum purchases required by the contract before Goliath terminated it.

But David also claimed damages for Goliath's breach of the implied covenant of good faith and fair dealing. David based the claim either wholly or partly on Goliath's exercise of the contractual termination right.

At trial, the only relevant jury question was as follows: "Do you find that [Goliath] breached its obligation of good faith and fair dealing to [David] in terminating the Contract by [Goliath's termination] letter of May 8, 1987?"[7] The jury said yes. It awarded damages in an amount comparable to those already awarded for breach of contract.

The New Jersey Supreme Court decided that the jury question quoted above really addressed Goliath's "good faith in performing, not terminating, the contract," and that the jury so understood it.[8] The Supreme Court said the facts gave a rational jury some basis to conclude that Goliath had exercised bad faith in performing the contract. Hence the jury verdict would stand.

Except by repeatedly stating that Goliath's mere exercise of its termination right could not breach the implied covenant of good faith and fair dealing, the court did not examine exactly what Goliath did to justify this additional award of damages, particularly after the jury had already compensated David for Goliath's breach of contract.

The court did say that a jury could reasonably reach the conclusion it did based upon Goliath's "performance during the contractual period, including the conduct surrounding the

7 148 N.J. at 412, 1997 N.J. Lexis 79, 32.

8 148 N.J. at 416, 1997 N.J. Lexis 39.

termination of the contract."[9] So, although mere exercise of a termination right may not be actionable (if the court says it enough times, then perhaps it will be true), David was nevertheless able to recover based at least in part on Goliath's "conduct" in how, why, and when it terminated the contract.

Given the plain language of the single relevant jury question and the fact that the New Jersey Supreme Court did seem to regard the circumstances of termination as relevant to the "implied covenant of good faith and fair dealing," it is not necessarily wrong to read this case as broadly as Barrett and Renard did in the last issue of "The Innkeeper."

Over time, *Sons of Thunder* may very well be remembered, perhaps oversimplistically, for the proposition that a jury can and will examine exactly why and how a party exercised a contractual termination right, and can award damages if it doesn't like what it finds.

If other states follow this approach, then contracting parties that negotiate for a discretionary termination right will have no reliable way to know whether they really have such a right, or whether a jury will decide later that the "escape hatch" isn't really as reliable as the Terminator might have thought.

This analysis will be based upon unpredictable evaluations of the Terminator's conduct (independent of pure "breach of contract") and state of mind.

Whenever any party exercises a unilateral termination right, or conceivably any discretionary right under a contract, it should perhaps plan ahead for the likelihood of a highly fact-sensitive litigation. This means generating a paper trail to establish innocent motivation. It means avoiding the creation of any evidence of impurity.

The entire history of the relationship could be relevant. The Terminator's motivations and internal discussions will be crucial. The potential scope of discovery will be quite broad.

As in so many other creative new areas of the law, the plaintiff's case will depend not so much on the misfortunes that actually befell the plaintiff -- facts of injury and causation that the plaintiff can prove without help -- but instead on the state of the defendant's mind, and what's in the defendant's files.

Every shred of correspondence, every email message, every set of notes on every meeting will become fair game, as it could show why and how the Terminator decided to terminate. Surely somewhere in that morass of paper any plaintiff will be able to find some "smoking gun," some sign of greediness or other impure motive, some overly frank written comment about, for example, how "we need to get rid of this guy."

That likelihood underscores, among other things, why a company might be tempted to have a "document retention policy" that says all documents will be retained for exactly

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[9] 148 N.J. at 424, 1997 N.J. Lexis 79, 54.

fifteen minutes and then destroyed, along with all backup and other machine-readable copies. Such a policy might apply with particular force to transitory internal memos and other potentially careless and casual communications -- anything that was written without assistance of counsel and hence perhaps without sensitivity to the breadth of the discovery process and the issues created by cases like *Sons of Thunder.*[10]

Planning ahead, every attorney who writes a contract with a discretionary termination right may now need to add several paragraphs of new verbiage to try to give teeth and meaning to that termination clause and preserve the flexibility it was intended to create.

The attorney now needs to persuade a court that an absolute right to terminate means an absolute right to terminate – "for any reason or no reason" or perhaps even arbitrarily and capriciously -- without regard to the history of the relationship, "greed" by the Terminator, personal animosity between the parties (which seemed perhaps to be part of Goliath's problem in *Sons of Thunder*), the Terminator's desire to stop doing business with the "victim" of the termination, the Terminator's desire to purchase the same product or service from another supplier, and so on.[11]

The resulting addition of half a page of new verbiage, perhaps partly in bold-face all capital letters, is much like the process that has produced 20-page guaranties, to persuade a court that the guarantor really is obligated to pay on the guaranty no matter what, and three-page "as-is" clauses in sophisticated contracts of purchase and sale, to persuade a court that the purchaser really intends to buy the property "as is."[12]

Drafters of discretionary termination rights might also want to consider whether a jury trial or a bench trial is more likely to produce outcomes like *Sons of Thunder.* The author would tend to believe the former. If this is true, then it is yet another argument for including an effective jury trial waiver in the documents for any commercial transaction.

Careful attorneys should perhaps go a step further. Perhaps they should rethink whether, in the current legal environment, contracts should be restructured to eliminate discretionary rights that a court might decide, after the fact, aren't really discretionary.

For example, in *Sons of Thunder*, perhaps Goliath should not have agreed to a five-year contract with a 90-day discretionary termination right. Instead, the contract should

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[10] Such a "document retention policy" would, of course, exclude final executed documents and documents that are already the subject of a litigation or for any other reason must be retained. The legalities, practicalities, and potential risks of such a "document retention policy" are outside the scope of this article. The discussion in text is not intended as a recommendation of such a policy, but merely to note its possible appeal in view of developing trends in the law.

[11] In negotiating a discretionary termination right, the Terminator would probably have thought that the Terminator preserved precisely this type of flexibility, but *Sons of Thunder* (if broadly interpreted) may mean the Terminator was wrong.

[12] *See* Stein, J., Cures for the (Sometimes) Needless Complexity of Real Estate Documents, Real Estate Review, Fall 1995.

perhaps have had only a 90-day term with a possibility of extension by later agreement. And then perhaps Goliath should have administered the contract so David couldn't possibly claim any reasonable expectation of automatic renewals.

Attorneys should also think about other contexts where similar issues may arise -- other areas where parties may think they have absolute discretion to do something that may hurt another party, but they might not really have as much discretion as they think they have.

What about loans payable on demand? What about discretionary margin calls in mortgage warehousing lines? What about any and all discretionary rights to consent to anything?

Might these areas also invite an inquiry into whether the party with discretion exercised it "in good faith" or for "ulterior" motives, taking into account the entire history of the relationship? In all these areas, doesn't the party with discretion often regard it as their "ace in the hole" if they change their mind about their counterparty or the transaction as a whole? Isn't that assumption now undercut? (Of course, the answer was probably yes already, so *Sons of Thunder* may just continue an unfortunate trend.)

If Barrett and Renard are right about how to read *Sons of Thunder*, then it is really a victory for no one at all except the plaintiff in the particular case (and possibly the paper shredding industry). It by no means represents a victory for hotel managers or a reason for anyone to want New Jersey law to govern a contract.

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Note from the Editors

Calendar of Events

Please see the Calendar of Events on the next page for upcoming events in the hotel, resorts, and timeshare industries.

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2000 Calendar Events

- CORNELL STRATEGY CONFERENCE/RESORT FORUM, MARCH, 19-21, 2000, Marriott Harbor Beach Resort, Ft. Lauderdale, Florida.
- ABA REAL PROPERTY, PROBATE & TRUST SECTION SPRING CLE MEETING, MARCH 22-24, 2000, Lowe's, Miami, Florida.
- AH&MA ANNUAL CONVENTION & LEADERSHIP FORUM, April 12-14, 2000, Phoenix Hyatt Downtown - Crown Plaza, Phoenix, Arizona.
- Fourth Annual Caribbean Hotel & Tourism Investment Conference, April 12-14, 2000, Sherbourne Center, Barbados, WI
- CORNELL UNIVERSITY 3RD ANNUAL EUROPEAN HOTEL INDUSTRY STRATEGY CONFERENCE, May 23-25, 2000, London Hilton on Park Lane, London, England.
- THE LODGING MANAGEMENT ACADEMY - No confirmed date.
- NYU 22ND ANNUAL INTERNATIONAL HOSPITALITY INDUSTRY INVESTMENT CONFERENCE, June 4-6, 2000, NY Marriott Marquee, New York City.
- ABA ANNUAL MEETING, July 6-12, 2000, Waldorf Astoria, New York City.
- THE LODGING CONFERENCE 2000, September 12-15, Arizona Biltmore, Phoenix, Arizona.
- THE CORNELL UNIVERSITY SCHOOL OF HOTEL ADMINISTRATION AND BICKEL & BREWER HOSPITALITY STRATEGY CONFERENCE, October, 4, 5, and 6, 2000, Cornell University, Ithaca, New York.
- NYU LATIN AMERICAN HOTEL AND RESORT INVESTMENT CONFERENCE, November 30 - December 1, 2000, Loews Miami Beach Hotel, Miami Beach, Florida
- PRACTICAL LAW INSTITUTE: STRATEGIES FOR HOTEL INVESTMENT, November 11- November 12, 2000, PLI Conference Center, 810 7th Avenue, 20th Floor, New York City.

FRANCHISE LAW UPDATE: *THE TOP TEN ISSUES FACING HOTEL COUNSEL* — **by Robert Zarco, Esq. Zarco & Pardo, P.A.**

1. Encroachment/ Protected Territory/Cross-Brand Protection

Significance of the Franchise Agreement's Language - The precise language in the franchise agreement will dictate whether a franchisee has the right to a protected territory, or even whether the franchisor must consider an existing franchisee's interests at all when evaluating where to locate a new hotel property. Courts tend to interpret these clauses *very* narrowly, and usually leave the franchisor with a great deal of discretion in its decision. A major focus of franchise litigation over the past several years has been disputes over the interpretation of these clauses. It is important to remember that in most circumstances, only the franchise agreement will define the franchisee's right to area protection. While some courts will consider the UFOC's statement on this issue, the franchisor's oral promises in determining what the parties originally intended will almost never be considered.

Formulation and Use of Impact Studies - Assuming that a franchisee has some right to be protected from the negative impacts of encroachment, certain hotel franchisors have employed "impact studies," or estimated projections as to how a new property might impact the existing franchisees operating in the area. In many cases, the franchisor will require the franchisee potentially affected to pay for the cost of the study - not an insignificant expense. The impact of a competing property may depress the existing hotel's occupancy rates, increase its marketing expenditures, result in lost food and beverage revenues, and decrease the hotel's resale value. Both franchisors and franchisees voice concerns that the methodology for these impact studies often varies from one case to another, and that the results may be subject to manipulation based on the study methodology employed. Even professional valuation associations have not yet devised specific, objective criteria to determine impact, as they have done for assessing property values, for example. It would be preferable to formulate standard criteria to be used industry-wide. In addition, the study should be performed by an expert who is "neutral."

2. Remodeling/Renovations

Determination of What Type of Renovations and Remodeling are Necessary - A franchisor may determine, as a result of a quality inspection, that a hotel property is in need of PIP, or a "property improvement plan." These renovations may be necessary because of normal wear and tear to the property, inadequate maintenance by the previous hotel owner, or the effects of a natural disaster, such as a hurricane. Alternatively, the franchisor may decide to impose a chain-wide remodeling program to enhance the brand's image. In either situation, the franchisee hotel will be responsible for paying the cost of the improvements.

One type of situation arises when the franchisee disputes the need for the remodeling. The franchisee may think that the franchisor is requiring Hyatt-quality level renovations in a Days Inn, for example. Some franchisee groups have called for the franchisee to be afforded the right to an independent quality inspection in these situations.

Another problem arises when, for one reason or another, the franchisee is unable to make the repairs as quickly as the franchisor has demanded. Many times, the franchisor will grant reasonable extensions of time for these matters if the franchisee follows the protocol for extensions. Franchisees encounter serious difficulties, including default and termination, when they do not follow the required procedure, or fail to do so in a timely manner. Counsel for both franchisor and franchisee recommend that the parties remain in communication about the status of the work in progress and document those conversations carefully to avoid any Liquidated misunderstandings.

3. Co-Branding Arrangements

Impact of the Franchise Agreement on a Franchisee's Freedom to Co-Brand - The idea of co-branding with a restaurant franchise may sound like a natural alliance, but there are some, potentially thorny legal issues to be resolved before embarking on such a venture. A hotel franchise agreement may impose certain restrictions on the types of businesses and/or products and services with which the hotel franchisee may share its property. For example, if the hotel offers food and beverage service, would a café as a guest concept be in violation of the franchise agreement because it may compete with the hotel's services?

The hotel franchise agreement may – depending upon the precise language of the contract – reserve the franchisor's right to approve of the guest concept's equipment and decor, before it begins operations. The franchisor may also have the prerogative, under the franchise agreement, to determine the guest concept's hours of operation and even to perform QSC (quality, service and cleanliness) inspections. These are just a few of the many legal questions which may arise in contemplating a co-brand relationship. It is not a simple decision for *any*

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of the parties involved, and a careful analysis of *all* applicable agreements by counsel is critical.

4. Reservations Systems
Use of Hotel Brand's Confidential Database - Franchisees voice several concerns regarding participation in a national brand's reservations system. In some systems, the franchisee pays additional fees to the franchisor in return for its participation in the nationwide system. As part of the process, the franchisee may provide occupation, pricing, and other proprietary information to the reservations system. The franchisees expect to receive confidential, technologically-efficient and a fair distribution of customers from that reservations system.

Occasionally, franchisees fear that the franchisor is using confidential, or competitively sensitive information from the reservations system to the advantage of company-owned hotels or for other improper purposes. Therefore, it is critical to the franchise relationship that franchisors maintain the confidentiality of the information supplied to its reservations database.

Other franchisee concerns pertain to reservation system employees recommending company-owned hotels rather than franchised hotels located in the same vicinity. The parent company should have a policy affording fair treatment to all of the hotels it represents, regardless of ownership status.

Franchisees have also experienced operational difficulties when the national reservations system's computer malfunctions. If a franchisee has signed a franchise agreement requiring it to participate in a computerized reservations system, the agreement may also contain a waiver clause absolving the franchisor of liability for computer difficulties with the system. This waiver clause will usually preclude the franchisee from suing to obtain damages for reservations revenue lost as a result of the malfunction.

In any event, all parties should work cooperatively to ensure that their information technology operates efficiently, as it will affect directly the hotel brand's financial results.

5. Vendor Exclusivity/ Supplier Control
Impact of the Franchise Agreement on Franchisor's Control of Vendors and Suppliers - Frequently, the franchise agreement will provide the franchisor with complete discretion in choosing third-party suppliers and vendors. Franchisees complain that these arrangements limit their ability to find the most cost-efficient suppliers and deprive them of the opportunity to forge their own network of business contacts. Franchisors, on the other hand, find that designating vendors and suppliers helps to maintain quality control and consistency within the concept.

Some franchise agreements leave the franchisees with an option to use their own suppliers if the products meet with franchisor approval for quality and uniformity; however, that option requires the franchisor to have a system in place for evaluating alternative suppliers. Should the franchisor fail to allow alternative vendors to be considered, it may be violating antitrust laws and other statutes protecting competition in the market. Franchisors must be prepared to justify the necessity of requiring franchisees to use a particular vendor or supplier based on the quality control, consistency or uniformity requirements of the franchise system. Such requirements must also be clearly disclosed in the UFOC.

6. Advertising/Marketing
Franchisor's Obligations Under the Franchise Agreement - A franchisor's obligation to provide advertising and other promotional services may be framed in terms of a discretionary requirement – the franchisor will provide advertising, for example, as it deems necessary. If the contract allows the franchisor to decide how much and what type of advertising the system needs, it does not matter that the franchisees believe that the advertising program is insufficient. Even if the requirement is set forth more objectively, it is often difficult to measure either party's expectations precisely whenever a certain amount of discretion is necessarily written into the contract. If the requirement does afford the franchisor discretion, there is still a requirement that the discretion be exercised in good faith. The franchisor must provide the franchisee with a reasonable level of marketing and advertising assistance. Otherwise, the franchisee may have a viable claim for breach of contract, or breach of the implied covenant of good faith and fair dealing.

Franchisor's Accountability for Marketing and Advertising Fees - Franchisees contribute a significant percentage of their revenue to franchisor-maintained marketing and advertising programs. The franchisors use those funds for promotional efforts on behalf of the hotel brand. Particularly where the parent franchisor owns a multi-brand portfolio of hotels, franchisees raise concerns that their contributions are not being used for their designated purpose. As a way to alleviate some of these concerns, franchisees often seek some method of franchisor accountability or reporting of their financial contributions. If a multi-brand hotel owner intends to "pool" the advertising funds among its several brands, the franchisor should specifically so state in the franchise agreement and the UFOC. Otherwise, the franchisor may subject the company to a viable franchisee lawsuit pertaining to advertising claims.

National vs. Regional and Local Advertising and Promotional Requirements - Franchisees in smaller markets are often concerned about not sharing the benefit of national franchisor advertising in the same way as

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smaller city hotels would prefer that the franchisor use their contributions to support regional or local advertising. Franchisors, on the other hand, find that national advertising is the most effective for promoting the system and enhancing the brand's image. Some franchise systems have attempted to resolve this dispute by forming advertising cooperatives, which allocate part of the advertising contribution for national advertising, and use the rest for local advertising programs. Regardless of the franchisor's approach to advertising, the franchisor must advise the franchisee in the franchise agreement and the UFOC as to what will be done with the advertising fund, and how the contributions will be allocated.

7. Sale/Transfer/ Assignment of the Franchise License

Restrictions on Sale or Transfer of the Franchise - Most franchise agreements allow the franchisor to withhold its consent to a proposed transfer or assignment unless and until the transferee meets certain, unspecified criteria. There are certainly legitimate reasons for requiring franchisor approval of a new operator. Nevertheless, franchisees fear that this grant of discretion will work to their disadvantage, and may interfere with their ability to sell their franchise for a fair price and leave the system. It is critical that franchisors and franchisees alike be able to rely on the transfer criteria set forth in . their counterparts in the major cities. Instead, the the approval of a prospective transferee, it is inappropriate for the franchisor to rely upon criteria outside of those set forth in the franchise agreement.

Imposition of Fees on Sale/ Transfer of Franchise License - Franchisees raise concerns about franchisors charging excessive fees in connection with the sale or transfer of the franchise license, fearing that they will lose a large part of their investment or be trapped within a system in which they no longer wish to participate. Franchisors, on the other hand, seek a way to recoup the administrative costs of transferring the license to the new owner. Either the transfer fee or a predetermined formula for calculating the fee should be stated clearly in the franchise agreement.

Impact of Franchisor's Assignment or Transfer of its Own Contractual Rights and Duties As part of the franchise agreement, franchisors may retain the freedom to assign or transfer their responsibility for furnishing various services to the franchise system to third parties; in so delegating, the franchisors are no longer responsible for providing those services. A major fear of franchisees is that the third party will not perform those services at the same level the franchisor was performing, due to lack of operational experience or financial resources. In the event they are dissatisfied, franchisees will be forced to deal directly with the third party, instead of with their franchisor instead of with their franchisor. This, of course, concerns franchisees because of fears that the third party will not have the same incentive as would the franchisor to furnish services at the highest caliber. Nevertheless, if the franchisor sells or transfers the franchise system to an unqualified purchaser, the system's franchisees may have a cause of action based on contract or even on business tort claims. For this reason, the franchisor must pick its successors prudently.

8. Mechanisms for Dispute Resolution

Mediation as a preferred alternative to litigation or arbitration, is a trend in dispute resolution. Mediation assumes that the parties will meet at the earliest possible opportunity to discuss their differences, under the guidance of a trained, neutral mediator to seek solutions which all parties can live with.

In contrast to the other alternatives, mediation encourages, rather than discourages, communication between the parties and seeks to preserve their relationship. Mediation is far less structured than the other avenues. It is a remedy after-the-fact in that its goal is to assess the conflict and negotiate damages, but it also affords a prospective remedy in that the parties may agree to their mutual expectations for future conduct.

Implicit in this list of positive attributes, however, is that there is a remedy that can fix the situation, that a compromise is possible, and that there are advantages to both parties to continue the relationship. Mediation is not suitable for all conflicts, and it is arguably the most effective when it is *chosen*, rather than *forced* upon parties as the only alternative available.

Nor is arbitration the preferable alternative that some believe it to be. First, it is very expensive. Arbitrators, unlike judges, are paid by the hour for all of their work, including attending hearings and reviewing all legal briefs and documentary evidence. Second, in arbitration, parties forfeit the right to extensive discovery and a jury trial. The normal rules of evidence and procedure do not usually apply in the same way as they would in state or federal court unless specifically set forth in the franchise agreement's arbitration clause. Instead, the law affords the arbitration panel a great deal of flexibility and discretion in conducting the arbitration hearing, and a reviewing court will rarely, if ever, reverse the panel's decision. For these reasons, the parties should think carefully about signing an agreement which mandates arbitration for dispute resolution and thereby waives their right to access the courts.

Although most parties do not wish to consider the prospect of litigation with their business partners, there are situations where litigation provides the best legal pro-

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tection for all involved. For this reason, it may be a serious disadvantage to foreclose the alternatives at the contracting stage.

9. Impact of Liquidated Damages Clauses on a Franchisee's Alternatives

Liquidated damages clauses are frequently cited as the most egregious of contract clauses. Liquidated damages provisions serve as a predetermined formula to compute monetary damages in the event of one party's breach (usually, the franchisee). The significance of this term is that it prevents a judge or jury from awarding damages, leaving the jury with only the determination of liability. Courts tend to uphold liquidated damages clauses, unless they would serve as a "penalty," or are truly "unconscionable" – and legally, these are both very high standards to meet. In addition, the court's decision as to whether a liquidated damages clause constitutes a penalty must consider the circumstances as they were at the time the parties entered the contract, not at the time of the dispute. As a practical matter, liquidated damages clauses deter franchisees from leaving one franchise system to join another system, and franchisors view liquidated damages as a remedy for the lost revenue in the market which the franchisee left prematurely.

In the lodging sector, liquidated damages are often based on the franchisee's royalty payments for a period of months -- at 60 months, for example. For a large property, this can be a severe penalty. In a recent effort to improve relations with its franchisee, at least one hotel franchisor has reduced its liquidated damages formula, and offers a 15% discount on damages due if the terminated franchisee complies with certain conditions, including de-identifying within 30 days of termination. These incentives promote fair franchising practices and provide incentives to the franchisee to comply expeditiously with the termination requirements.

No Effect If the Franchisor Breaches First - If the franchisor commits a material breach of the contract, then the liquidated damages clause will not apply at all. Nevertheless, the issue of which party has breached first is not always easy to determine. For this reason, the threat of liquidated damages often casts a dark cloud over the franchise relationship.

No Effect if the Franchisor Replaces the Franchisee Immediately - Other issues arise when the franchisor replaces the terminated franchisee in the same market immediately, and therefore, does not suffer a loss of brand representation and royalty revenue in that market. In certain cases, the franchisor may be prohibited from collecting the liquidated damages from the franchisee because, if the projected financial losses do not actually occur, the liquidated damages would constitute a "double recovery."

10. Construction/ Development/Site-Selection Issues

Franchisor's Obligations Regarding Site Selection - Does the franchise agreement require the franchisor to recommend or actually to choose a location or a site? A location decision means that the franchisor will decide to expand into a certain area. Once the location is chosen, who is responsible for choosing the actual site? What are the franchisor's established criteria for making that decision, and thus, reducing the risk of financial loss to the franchisee? This is a critical decision, and it is important that the parties know well in advance which of them is responsible for selecting the actual property site. If the franchisor fails to adhere to its own site selection criteria when it selects or approves the franchisee's site, the injured franchisee may possess viable claims as a result of the franchisor's failure to follow its own guidelines.

The construction of a hotel necessarily involves significant costs. The evaluation process ordinarily begins with a feasibility study, of which the project's financing arrangements are a major focus. The feasibility study also considers the total project cost, the financial structure of the undertaking, and the projected tax consequences of the venture.

A feasibility study for a hotel will consider a much larger area than would a new restaurant business. The hotel study will likely consider the entire city, or community, as a market, and differs from market studies for restaurants in that the demand comes from outside the local area, rather than from within it. A thorough feasibility study will contain a site review and area evaluation, a market demand analysis, a review of economics and demographic indicators, a competitive analysis, facilities and concept recommendations, a forecast of revenue and expenses, an estimate of total project cost, and a return on investment analysis. To be prepared properly, the study will involve considerable time and expense for the responsible party.

Franchisee's Responsibility to Remain Current with Development Schedule - If the franchisee is a multi-unit operator, the franchisee will be responsible for staying current with the development schedule set forth in the franchisee agreement. Failure to do so, without the franchisor's *written* approval, will result in the franchisee's default and the potential termination of the franchise agreement. It is in the interest of both parties, to consider whether the development schedule is realistic – given all of the relevant factors – before it actually becomes part of the parties' contract. If, however, the franchisor impedes, or in any way interferes with the franchisee's ability to comply with the development schedule for real or pretextual reasons – i.e., to promote the development of company-owned out-

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fets at the expense of franchised units – the franchisor will not be permitted to default or terminate the franchisee on this basis, and may subject itself to liability for its actions.

Conclusion

Franchisee and franchisors are partners in this business relationship. For this reason, franchisees and franchisors alike must be acutely aware of their respective rights and responsibilities under the franchisee agreement. Both parties should also stay current as to the state of the law and how changes in the law will affect the interpretation, construction and performance of the franchise contract. If either party is unsure of how to proceed in a given situation, the best advice is to consult with an experienced franchise attorney at the earliest possible opportunity.

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*TRADEMARKS VS. CYBERSQUATTERS: THE SAGA CONTINUES** — **by Michael K. Lindsey of Paul, Hastings, Janofsky & Walker LLP, Los Angeles**

The miraculous new medium of the Internet has proven to be a bruising battleground for trademarks. The owners of well-recognized marks have been forced to litigate or buy off "cybersquatters," profiteers who register identically worded or occasionally slightly misspelled domain names. Companies engaged in product development have been chagrined to find that, even before their products are released, others have registered the product name selected and variations that were being considered. Even political candidates have found domain names registered to other, quicker actors.

A Ninth Circuit decision from last year, new federal legislation and new international rules for domain name dispute resolution have been hailed by trademark owners as appropriately recognizing the priority of trademark over domain name rights. The Ninth Circuit decision, *Brookfield Communications Inc. v. West Coast Entertainment Corp.*, __F. 3rd__, 1999 WL 232014 (9th Cir 1999), held that "registration of a domain name for a Web site does not trump long-established principles of trademark law." The plaintiff Brookfield Communications had started marketing entertainment industry software under the "MovieBuff" trademark in 1993, subsequently began using that mark on an entertainment database and then registered the mark with the Patent and Trademark Office in 1998. The defendant West Coast operated 500 video rental stores under the service mark "The Movie Buff's Movie Store," for which it secured a federal service mark registration in 1991. West Coast also registered the domain name "moviebuff.com" in 1996 but made no significant use of its website until November 1998, when it announced that it intended to launch a searchable entertainment database at the site.

In response to Brookfield's request for injunctive relief on trademark infringement grounds, West Coast argued that it had priority, having used "The Movie Buff's Movie Store" since 1986. The Ninth Circuit, though, found that "The Movie Buff's Movie Store" was sufficiently different from "moviebuff.com" that the defendant could not tack its trademark priority onto use of its domain name. The court specifically noted that "registration with Network Solutions . . . does not in itself constitute 'use' for purposes of acquiring trademark priority."

Accordingly, Brookfield was found to be the prior user: "West Coast's first use date was neither February 1996 when it registered its domain name with Network Solutions . . . , nor April 1996 when it first used 'moviebuff.com' in e-mail communications, but rather November 1998 when it first made a widespread and public announcement about the imminent launch of its web site. Thus, West Coast's first use of 'moviebuff.com' was preceded by Brookfield's first use of 'MovieBuff' in conjunction with its online database, making Brookfield the senior user."

The court followed a traditional trademark infringement analysis in determining a likelihood of confusion if West Coast were permitted to use its registered domain name. Thus, the court found similarity of the plaintiff's mark and the domain name, and a likelihood of confusion because of the competitive overlap of Brookfield's software and West Coast's online database that could perform a similar function. In doing so, the court noted, "The domain name is more than a mere address: like trademarks, second-level domain names communicate information as to source."

The court also held that any use of the "MovieBuff" trademark as a metatag would constitute infringement, as it would result in initial interest confusion rather than source confusion. A metatag is a piece of HTML code invisible to a human viewer but designed to describe the contents of a website to an Internet search engine. By using the "MovieBuff" mark as a metatag, West Coast would inevitably attract a number of consumers originally looking for Brookfield's products but who, upon arriving at the West Coast site, might content themselves with West Coast's offerings because of their similarity to Brookfield's products. The court summarized its conclusion by stating, "Using another's trademark in one's metatags is much like posting a sign with another's trademark in front of one's store." Accordingly, the Ninth Circuit reversed the district court and remanded with instructions to enter an injunction against West Coast's use of "MovieBuff" in its domain name or website metatags.

The *Brookfield* case was followed one week later by the World Intellectual Property Organization's publication of its lengthy Final Report on the Internet Domain Name Process. (The complete report may be found at http://wipo2.wipo.int/process/eng/final_report.html.) Among other things, the Final Report recommended that the owners of famous or well-known trademarks be exclusively entitled to register those marks as domain names, that a domain name registrant have the burden of justifying any domain whose name is misleadingly similar to any such mark, and that the Internet Corporation for Assigned Names and Numbers (ICANN) adopt a dispute

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resolution mechanism for allegations of cybersquatting.

The WIPO acknowledged the widespread problem of abusive registration of domain names, a term which it said encompasses practices ranging from cybersquatting, or the deliberate, bad faith abusive registration of a domain name in violation of trademark rights, to warehousing, or the registration of a collection of domain names corresponding to trademarks in anticipation of selling the domain names to the trademark owners. The WIPO also acknowledged that existing remedies for such practices are frequently ineffective, quoting one commenter as saying, "for each reported case, Panavision, Spice Girls, Burger King, British Telecom, there are a myriad of others that have to be resolved outside the court room, but at significant cost to the companies and to the consumers who buy their brand of products." Accordingly, the WIPO recommended the adoption of an expedited administrative procedure for the resolution of all cases of abusive registration.

The Final Report also addressed the long-debated subject of increasing the number of generic top-level Internet domains (gTLDs) such as .com, .net and .org. The report noted the diversity of views on this subject, ranging from the free market view that anyone should be entitled to create a new gTLD to the *status quo* view that any new gTLDs would merely aggravate existing intellectual property problems and lead to consumer confusion. Further, the move to create new gTLDs was originally fueled in part by a desire to increase competition in gTLD registration activities; now that ICANN has designated other registrars to act in competition with Network Solutions, this motivation has evaporated. On balance, the report concluded, "new gTLDs can be introduced, provided that they are introduced in a slow and controlled manner" and the report's other recommendations are adopted.

The U.S. Congress provided trademark owners with a formidable new weapon last November when it adopted the Anticybersquatting Consumer Protection Act, 15 U.S.C. § 1125(d). This Act makes cyberpiracy a separate violation of the federal statute protecting trademarks. Specifically, any person who has a bad faith intent to profit from another's mark (e.g., selling the mark), and registers a domain name that is identical or confusingly similar to a distinctive or famous mark of another, violates the Act. Penalties for any such violation include the court-ordered transfer of the domain name, injunctive relief preventing any further such acts, actual damages and lost profits, statutory damages up to $100,000 per domain name, court costs and attorneys' fees. Hundreds of actions under the Act have been filed across the country, resulting in several reported decisions in favor of trademark owners as well as a general market decline in the asking price generally sought by cybersquatters for turning over their improperly registered domains.

ICANN also responded late last year to WIPO's call for action by adopting a new Uniform Domain Name Dispute Resolution Policy, which may be found at http://www.icann.org/udrp/udrp.htm. Under the policy, disputes arising out of cybersquatting and similar types of abusive domain name registrations may be resolved through expedited administrative proceedings conducted by ICANN-sanctioned dispute resolution services. The first such dispute, appropriately involving the domain name "worldwrestlingfederation.com," was resolved through the WIPO Arbitration and Mediation Center within five weeks after commencement of the proceeding, at modest legal cost to the litigants (see http://arbiter.wipo.int/domains/decisions/index.html).

While these judicial, legislative and administrative developments have been warmly received by trademark owners, particularly those with established trademarks and international operations, cybersquatting remains a problem that has not been completely conquered. Further, both the WIPO report and the Anticybersquatting Act leave open the definition of what exactly constitutes a famous or well-known trademark entitled to protection. While "Hilton," "Coca-Cola" and "Mercedes" would undoubtedly qualify, many other well-regarded marks might not satisfy the standard and far fewer protections are available for other, less well-known marks. Finally, the range of practices that could constitute cybersquatting is not fully resolved by any of the authorities.

ICANN continues to consider the issue of additional gTLDs. At meetings this month in Cairo, one of ICANN's constituent bodies received two working group reports with diametrically opposite recommendations, and it is likely that this issue will not be resolved until the fall of this year at the earliest. Thus, at the same time as trademark owners are starting to feel somewhat content with the level of protection available on the Internet, additional gTLDs may provide new territory in which the saga of trademarks vs. domain names will continue.

* Revision of article originally published as "Just an Address," Los Angeles Daily Journal (6/18/99) at 7, and cited in *Avery Dennison Corp. v. Sumpton*, __ F.3rd __ (9th Cir. 1999). ■