

Management Alert

Federal Court Sends Franchisee-Franchisor Trade Secret and Breach of Contract Dispute To Arbitration

In a decision that has implications for those drafting arbitration provisions for franchise agreements, a federal district court in Arizona recently granted a franchisee's motion to compel arbitration in a trade secret and breach of contract dispute with its franchisor.

Apart from its colorful facts, the court's ruling is significant for several reasons. First, it demonstrates that franchisors that include arbitration provisions in their franchise agreements may be precluded from obtaining immediate injunctive relief in court against their franchisees, particularly where they include provisions that only permit the franchisor to obtain injunctive relief outside the arbitration proceeding (at least under Arizona law). Next, it demonstrates that a nonsignatory to a franchise agreement may be permitted to compel arbitration in the Ninth Circuit where the signatory's claim against the nonsignatory involves a dispute that is "intertwined with the contract providing for arbitration."

The decision is also a reminder that although binding arbitration with franchisees may be beneficial, franchisors must keep abreast of the ever-changing law in the governing jurisdiction(s) to ensure that arbitration rather than litigation in the courts is the appropriate dispute resolution forum for their business objectives. Simply put, if a rogue franchisee's actions put a franchisor's system in jeopardy, a franchisor may not be willing to put the fate of its misappropriated intellectual property in the hands of an arbitrator whose ultimate decision may be subject to limited judicial review.

The Facts

In *Noodles Development, LP v. Latham Noodles, LLC*, 2009 WL 2710137 (D. Ariz. August 26, 2009), a federal district court in Arizona (District Judge Neil V. Wake, presiding) granted the franchisee's motion to compel arbitration and stayed the civil action initiated by the franchisor.

The plaintiff, a franchisor owning the rights to the "Nothing But Noodles" franchise of restaurants, entered into a franchise agreement with the defendant franchisee which permitted the franchisee to open a franchise in New York.

The franchise agreement provided that "any dispute or claim relating to or arising out of this Agreement must be resolved exclusively by mandatory arbitration by and in accordance with the Commercial Arbitration Rules of the American Arbitration Association ("AAA") or another arbitration service agreed to by the parties."

The franchise agreement also provided *the franchisor* with the right to petition a court of competent jurisdiction for the entry of temporary and permanent injunctions of specific performance enforcing the provisions of the franchise agreement relating to “(a) Franchisee’s use of the Marks or the System ...; (d) Franchisee’s violation of the provisions of this Agreement relating to confidentiality and the covenants not to compete; and (e) any act or omission by Franchisee or Franchisee’s employees that ... (2) is dishonest or misleading to the guests or customers of the Franchised Restaurant or other Nothing But Noodles Restaurants ..., or (4) may impair the goodwill associated with the Marks or the System.”

The franchisor challenged the franchisee’s motion on the grounds that 1) the agreement did not encompass the claims that it had brought against the franchisee; 2) it need not first arbitrate the substantive merits of its claims because pursuant to the franchise agreement it may bring an action for injunctive relief before the court and principles of judicial economy should allow it to litigate its damages claims in court as well; and 3) it need not arbitrate with one of the co-defendants because he was not a signatory to the franchise agreement. The court rejected all three of the franchisor’s arguments.

The Court’s Reasoning

The court began its analysis by first stating that the franchisee agreement requires arbitration of “any dispute or claim relating to or arising out of this Agreement.” It noted that the Ninth Circuit has observed that the phrase “arising out of or relating to” creates an arbitration clause that is “broad and far reaching” in scope. The court found that an arbitration clause with a broad and far reaching scope “reaches every dispute between the parties having a significant relationship to the contract and all disputes having their origin or genesis in the contract.”

The court stated that, to require arbitration, the factual allegations of the complaint “need only ‘touch matters’ covered by the contract containing the arbitration clause.”

The court found that *all of the facts* alleged in the franchisor’s complaint have a significant relationship to the franchise agreement. The court noted that the complaint alleges trademark and trade dress infringement, misappropriation of trade secrets, and breach of contract. The court reasoned that the factual predicate of these claims was the franchisee’s alleged misuse of the Nothing But Noodles marks and system. Because the franchisee’s use of the Nothing But Noodles marks and system was the core subject of the franchise agreement, the court found that the franchisor’s claims have a significant relationship to the franchise agreement and must be arbitrated.

The court also noted that the franchisor alleged that franchisee tortiously interfered with its business relationships. The court found that the claim was significantly related to the confidentiality clauses and covenants not to compete in the franchise agreement and an area development agreement signed by the parties, which also contained an arbitration clause. The area development agreement provided the franchisee with the right to sell new franchises on behalf of the franchisor. The court stated that the franchisor alleged that the franchisee had instead been soliciting existing Nothing But Noodles franchises to re-brand their restaurants under another mark.

The court found that the facts of this allegation were *significantly related* to the franchisee’s duties as a representative of franchisor under the area development agreement, especially those provisions relating to confidentiality and competition. The court found that the franchise agreement therefore required arbitration of the tortious interference claim.

In sum, the court found that the substance of each claim asserted by the franchisor in its complaint was covered by the arbitration agreement and therefore could not be adjudicated by the court.

Problematic One-Sided Injunction Provision May Preclude Injunctive Relief in Court

Next, the court acknowledged that the franchise agreement does, however, reserve to the franchisor the ability to seek preliminary or permanent injunctive relief in court for certain types of claims. The court remarked that typically courts in [the Ninth Circuit] may not grant preliminary injunctive relief where interim relief is available from an arbitral tribunal.

The court found, however, that the terms of the agreement control the scope of the arbitration clause in the suit. The franchise agreement specifically permitted *the franchisor* to seek injunctive relief from the court despite the availability of such relief under the rules of the AAA.

However, the court found that the franchise agreement did not specify whether the franchisor may seek permanent injunctive relief in court before obtaining a substantive determination of the merits of its claims from an arbitral tribunal. The franchisor argued that it need not first arbitrate the substantive merits of its claims and that, because it may bring an action for injunctive relief before the court, principles of judicial economy should allow it to litigate its damages claims in court as well.

The court found that such an interpretation nullified the arbitration clause because once the court decided the merits of the franchisor's claims, there was little purpose in involving an arbitral tribunal. The court found that the franchisor's interpretation conflicted with the parties' demonstrated intent to have an arbitral tribunal, not a court, decide the merits of "any dispute or claim arising out of or related to" the franchise agreement.

The court stated that the franchise agreement's injunction provision may simply be intended to preserve the availability of a court to impose an injunctive remedy, rather than decide the merits of the claims. "In other words, it may allow Franchisor to seek preliminary injunctive relief to maintain the status quo during arbitration and to seek permanent injunctive relief if the arbitral tribunal rules in its favor." The court found that this interpretation was equally as plausible, if not more plausible than the franchisor's interpretation. The court held that the ambiguous relationship between the franchise agreement's arbitration clause and the injunction provision must be reconciled in favor of arbitration.

The court found that the franchisor may seek emergency injunctive relief to preserve the status quo while it arbitrates, but it must obtain a substantive determination of the merits of its claims from an arbitral tribunal before applying for a permanent injunction from the court. The court noted that the franchisor had not yet moved for any emergency injunctive relief.

The court also stated that at least one court (*Wernett v. Serv. Phoenix, LLC*, 2009 U.S. Dist. LEXIS 62593 at *26-28, 2009 WL 1955612 at *8 (D.Ariz. July 6, 2009)) had recently held that, under Arizona law, an arbitration agreement that reserves the right to seek judicial injunctive relief to only one party is substantively unconscionable. The court stated that, should the franchisor seek preliminary injunctive relief from the court instead of from the arbitral tribunal, it will first have to address the validity of the franchise agreement's "**one-sided injunction provision under Arizona law.**"

Claims Against Non-signatory Defendants Subject to Arbitration

Lastly, the franchisor argued that it need not arbitrate with one of the co-defendants because he was not a signatory to the franchise agreement. The court stated that a nonsignatory to an arbitration agreement may estop a signatory from refusing to arbitrate its claim against the non-signatory where the dispute is "intertwined with the contract providing for arbitration." "[A]pplication of equitable estoppel is warranted ... when the signatory to the contract containing the arbitration clause raises

allegations of ... substantially interdependent and concerted misconduct by both the non-signatory and one or more of the signatories to the contract.”

The court noted that the complaint alleges that “the Individual Guarantors and [non-signatory] Defendant . . . have contacted Noodles’ franchisees and made attempts to induce such franchisees into breaching their respective agreements with Noodles.” The court found that the complaint therefore raises allegations of substantially interdependent and concerted misconduct by the non-signatory defendant and the defendant signatories to the franchise agreement. Accordingly, the court found that the franchisor was estopped from refusing to arbitrate its claim against the non-signatory defendant.

The court stayed the civil action until the arbitration has been completed, having concluded that all claims in the suit were subject to arbitration, but indicated that the franchisor may apply to the court for **injunctive remedies**.

Lessons Learned

The court’s decision has a number of general take-aways for franchisors. Depending upon the applicable jurisdiction, franchisors should consider making it clear that both parties to the franchise agreement can seek injunctive relief to avoid the result in *Noodles Development, LP*.

As a threshold matter, franchisors should carefully consider whether to include an arbitration provision in their franchise agreement. Arbitration can provide a number of benefits to franchisors, such as a cost-effective and seemingly uniform method of resolution with franchisees. However, depending upon the applicable governing law, there can be significant drawbacks such as having to pay for the costs of the arbitration, losing or having a limited right to seek immediate injunctive relief in a court of law, only having a limited review of arbitration decisions, and having non-signatories to the arbitration agreement made part of the arbitration proceeding.

Before including arbitration provisions in their franchise agreements, franchisors should consult counsel to determine the ever-changing state of the law in the governing jurisdiction and decide whether arbitration provides an adequate forum to protect any misappropriated intellectual property, such as the franchisor’s system, as well as determine whether arbitration meets their business objectives.

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