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**Unsigned Obligations:
When Are Non-Signatories Bound?**

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UNSIGNED OBLIGATIONS: WHEN ARE NON-SIGNATORIES BOUND?

I. INTRODUCTION

When parties enter into a franchise agreement, they reasonably assume that they can enforce the agreement against the signatories. However, although the franchisee signatory may be an individual, a few individuals, or a closely held corporation or partnership owned by those individuals, the signatories' family, close colleagues, or a hired manager may participate in the operation of the franchised unit. These individuals likely will have access to trade secrets and other confidential information about the franchise that make it competitive. What remedies does a franchisor have if these individuals decide to use the information they obtained in operating the franchised unit to open up a competitive business, either during the term of the franchise agreement or after it terminates? These individuals also may engage in conduct in the course of operating the franchised unit that violates or is contrary to the purpose and intent of the franchise agreement. What remedies are available to enforce franchise agreement protections against such individuals when they are not parties to the agreement?

This paper addresses some of the thorny issues that arise in attempting to enforce contracts, including franchise agreements, against non-signatories. The paper focuses primarily on two types of contractual provisions that are common in franchise agreements and have generated significant litigation where parties seek to bind a non-signatory: agreements to arbitrate disputes and non-compete agreements. As will become apparent, simply avoiding signing an agreement may not insulate a person from contractual provisions, but whether a party will succeed in enforcing a contractual provision against a non-signatory will depend on the facts of the particular circumstance.

II. AGREEMENTS TO ARBITRATE

A. The Federal Arbitration Act and its Broad Scope

Section 2 of the Federal Arbitration Act ("FAA") provides:

A written provision in any . . . contract evidencing a transaction involving commerce to settle by arbitration a controversy thereafter arising out of such contract or transaction, or the refusal to perform the whole or any part thereof, or an agreement in writing to submit to arbitration an existing controversy arising out of such a contract, transaction, or refusal, shall be valid, irrevocable, and enforceable, save upon such grounds as exist at law or in equity for the revocation of any contract.¹

The United States Supreme Court has held that § 2 of the FAA "is a congressional declaration of a liberal federal policy favoring arbitration agreements."² The Court has made clear that § 2 of "the FAA was designed to promote arbitration" and it embodies "a liberal federal

¹ 9 U.S. § 2.

² *Perry v. Thomas*, 482 U.S. 483, 489 (1987) (quoting *Moses H. Cone Mem'l Hosp. v. Mercury Constr. Corp.*, 460 U.S. 1, 24 (1983)).

policy favoring arbitration agreements, notwithstanding any state substantive or procedure policies to the contrary.”³ Arbitration agreements falling within the scope of the FAA “must be ‘rigorously enforce[d]’.”⁴ Indeed, the FAA “leaves no place for the exercise of discretion by a district court, but instead mandates that district courts *shall* direct the parties to proceed to arbitration.”⁵ An agreement to arbitrate is presumed to be valid and enforceable.⁶

A court must compel arbitration where: (1) a valid agreement to arbitrate exists and (2) the claims fall within the scope of the arbitration agreement.⁷ So, for example, “a party may not be compelled under the FAA to submit to class arbitration unless there is a contractual basis for concluding that the party *agreed* to do so.”⁸ “The ‘principal purpose’ of the FAA is to ‘ensur[e] that private arbitration agreements are enforced according to their terms.’”⁹ “[N]othing in the [FAA] authorizes a court to compel arbitration of any issues, or *by any parties*, that are not already covered in the agreement.”¹⁰

When presented with a motion to stay litigation pending arbitration under section 3 of the FAA, a court’s inquiry is limited to whether an agreement to arbitrate exists and whether it encompasses the issue in dispute.¹¹ Section 3 of the FAA requires a court to stay an arbitrable action pending arbitration: “[T]he court . . . , upon being satisfied that the issue involved in such suit or proceeding is referable to arbitration under such an agreement, shall on application of one of the parties stay the trial of the action until such arbitration has been had in accordance with the terms of the agreement”¹² Courts have construed this provision strictly. Significantly,

³ *AT&T Mobility LLC v. Concepcion*, 131 S. Ct. 1740, 1749 (2011) (quoting *Moses H. Cone Mem’l Hosp.*, 460 U.S. at 24 (1983) and *Buckeye Check Cashing v. Cardegna*, 546 U.S. 440, 443 (2006)).

⁴ *Perry*, 482 U.S. at 490 (citations omitted).

⁵ *Dean Witter Reynolds, Inc. v. Byrd*, 470 U.S. 213, 218 (1985) (emphasis in original).

⁶ See *Shearson/American Express, Inc. v. McMahon*, 482 U.S. 220, 226 (1987). Arbitration agreements presumptively cover the subject matter of the parties’ disputes, until proven otherwise. *Moses H. Cone*, 460 U.S. at 24. Any doubts concerning the scope of arbitrable issues should be resolved in favor of arbitration. The Supreme Court has long held that any party resisting arbitration bears the burden of proving that the claims at issues are not suitable for arbitration. *Green Tree Financial v. Randolph*, 531 U.S. 79, 91 (2000).

⁷ *Green Tree Fin. Corp. v. Bazzle*, 539 U.S. 444, 452 (2003).

⁸ *Stolt-Nielsen S.A. v. AnimalFeeds Int’l Corp.*, 559 U.S. 662, 684 (2010) (emphasis in original); see also *Rosen v. SCIL, LLC and Saks, Inc.*, 799 N.E.2d 488, 494 (Ill. App. 2003) (“If plaintiff did not wish to agree to the new terms in his credit card agreement, he simply should have stopped using the card. We find the arbitration provision enforceable despite its prohibition on class actions.”).

⁹ *AT&T Mobility*, 131 S. Ct. at 1748 (quoting *Volt Info. Sciences, Inc. v. Bd. of Trustees of Leland Stanford Jr. Univ.*, 489 U.S. 468, 478 (1987) and citing *Stolt-Nielsen*, 559 U.S. at 664)).

¹⁰ *Stolt-Nielsen*, 559 U.S. at 683 (quoting *EEOC v. Waffle House, Inc.*, 534 U.S. 279, 289 (2002)) (emphasis in original).

¹¹ *Reid v. Do Run Resources Corp.*, 701 F.3d 840, 845-46 (8th Cir. 2012); see also *Jensen v. Quik Int’l*, 820 N.E.2d 462, 465 (2004); *Ragan v. AT & T Corp.*, 824 N.E.2d 1183, 1187 (Ill. App. Ct. 2005) (citing *Jensen*, 820 N.E.2d at 465).

¹² 9 U.S.C. § 3; *AT&T Mobility*, 131 S. Ct. at 1748 (quoting 9 U.S.C. § 3).

“[i]f the court finds that an agreement to arbitrate exists and the issue presented is within the scope of that agreement, a stay under section 3 of the FAA is mandatory.”¹³

Furthermore, the mere presence of defendants not subject to the arbitration provision does not prevent the Court from compelling a party to an arbitration clause to arbitrate. “Under the Arbitration Act, an arbitration agreement must be enforced notwithstanding the presence of other persons who are parties to the underlying disputes but not to the arbitration agreement.”¹⁴ Alternatively, a court may dismiss an action where all of the plaintiff’s claims will be resolved in arbitration.¹⁵

Due to the broad policies favoring arbitration, courts may require arbitration, even if the party against whom arbitration is being compelled has not signed a written arbitration agreement. For example, a consumer is bound to the terms of a contract containing an arbitration clause when the consumer has been provided the contractual terms and has been given an opportunity either to reject the terms or accept the transaction, and fails to reject the terms of the transaction.¹⁶

In *Imperial Savings Assoc. v. Lewis*, plaintiff, an insured mortgagee, filed a lawsuit against its title insurer seeking indemnification after a third party filed a mechanic’s lien on the insured property.¹⁷ The title insurer sought to compel arbitration pursuant to the arbitration provision contained in the title insurance policy.¹⁸ The plaintiff had received the title insurance policy 11 months earlier and had not objected to its terms. The federal district court in Utah compelled arbitration, even though the plaintiff had not signed the title insurance policy, holding that the “receipt of the Policy in early August 1988, with no objection to the arbitration provision until July 18, 1989, is an acceptance of all the terms of the Policy as a matter of law.”¹⁹

¹³ *Reid*, 701 F.3d at 845-46; see also *Jensen*, 820 N.E.2d at 465; *Ragan*, 824 N.E.2d at 1187 (citing *Jensen*, 820 N.E.2d at 465).

¹⁴ *J & K Cement Const., Inc. v. Montalbano Builders, Inc.*, 456 N.E.2d 889, 900-01 (Ill. App. Ct. 1983) (quoting *Moses H. Cone Mem. Hosp.*, 460 U.S. at 20).

¹⁵ See *Sparling v. Hoffman Constr. Co.*, 864 F.2d 635, 638 (9th Cir. 1988) (holding that the court properly dismissed the case because “the arbitration clause was broad enough to bar all of the plaintiff’s claims since it required [the plaintiff] to submit all claims to arbitration.”).

¹⁶ See, e.g., *Hill v. Gateway 2000, Inc.* 105 F.3d 1147, 1150 (7th Cir. 1997)(holding that by electing to keep the computer rather than returning it within the time period provided, the consumer agreed to be bound by an arbitration provision provided by the seller); *ProCD, Inc. v. Zeidenberg*, 86 F.3d 1447, 1452 (7th Cir. 1996); see also *Imperial Savings Assoc. v. Lewis*, 730 F. Supp. 1068, 1073 (D. Utah 1990); *Commercial Union Assoc. v. Clayton*, 863 P.2d 29, 34 (Utah Ct. App. 1993) (Under Utah law, “parties may become bound by the terms of a contract even though they did not sign the contract, where they have otherwise indicated their acceptance of the contract, or led the other party to so believe that they have accepted the contract.”) (citations omitted).

¹⁷ 703 F.Supp. at 1068.

¹⁸ *Id.* at 1071.

¹⁹ *Id.* at 1073; see also *Hill*, 105 F.3d at 1150. “Illinois courts have recognized that silence can constitute an acceptance of an offer when it is reasonable, because of prior dealings or otherwise, that the offeree should notify the offeror if he does not intend to accept the offer.” *Ragan v. AT & T Corp.*, 824 N.E.2d 1183, 1188 (Ill. App. Ct. 2005). See also *Ramette v. AT&T Corp.*, 812 N.E.2d 504, 515 (Ill. App. Ct. 2004) (“The CSA Mailing provided a method for customers to reject the terms offered by AT&T. Ramette had the option to call a toll-free number and cancel his services with AT&T. Ramette did not cancel his AT&T service and accepted the terms of the CSA by continuing to

B. Enforcement of Arbitration Agreements

Whose job is it to decide whether parties to an agreement have agreed to arbitrate particular issues? Under the Federal Arbitration Act, courts have the authority to decide limited “gateway” issues unless the parties agree otherwise.”²⁰ “Gateway” issues include whether “parties have a valid arbitration agreement at all or whether a concededly binding arbitration clause applies to a certain type of controversy.”²¹ “The question whether the parties have submitted a particular dispute to arbitration, *i.e.*, the ‘*question of arbitrability*,’ is ‘an issue for judicial determination [u]nless the parties clearly and unmistakably provide otherwise.”²²

Contract interpretation issues, however, are typically decided by an arbitrator where the parties have agreed to arbitrate and the issues fall within the scope of the arbitration agreement. In *Prima Paint Corp. v. Flood & Conklin Manufacturing Co.*²³ the Supreme Court held that federal courts may not delay granting a stay of a court action to permit arbitration for the purpose of adjudicating a plaintiff’s claim for fraud in the inducement of the contract generally.²⁴ Rather, a federal court may only adjudicate a claim of fraud in the inducement of the arbitration clause in particular.²⁵ The Court held that “in passing upon a § 3 application for a stay while the parties arbitrate, a federal court may consider only issues relating to the making and performance of the agreement to arbitrate.”²⁶

In *Buckeye Check Cashing, Inc. v. Cardegna*,²⁷ the Court made clear that its decision in *Prima Paint Corp.* was not limited to federal courts and was not merely a rule of procedure. The Court held that “regardless of whether the challenge is brought in federal or state court, a challenge to the validity of the contract as a whole, and not specifically to the arbitration clause, must go the arbitrator.”²⁸ Examples include challenges “either on a ground that directly affects the entire agreement (*e.g.*, the agreement was fraudulently induced), or on the ground that the

use his AT&T service.”); *Fineman v. Citicorp USA, Inc.*, 485 N.E.2d 591, 595-96 (Ill. App. Ct. 1985) (holding that failure to respond to a mailed notification of an amendment of a credit card agreement constituted acceptance of the terms).

²⁰ See *Green Tree Financial Corp. v. Bazzle*, 539 U.S. 444, 452-453 (2003).

²¹ *Id.* at 452.

²² *AT&T Technologies, Inc. v. Communications Workers*, 475 U.S. 643, 649 (1986) (emphasis added).

²³ 388 U.S. 395 (1967).

²⁴ *Id.* at 403-04, 406-07.

²⁵ *Id.* at 403-04.

²⁶ *Id.* at 404.

²⁷ 546 US 440 (2006).

²⁸ *Id.* at 449.

illegality of one of the contract's provisions renders the whole contract invalid."²⁹ The Court articulated the principles guiding its holding:

First, as a matter of substantive federal arbitration law, an arbitration provision is severable from the remainder of the contract. Second, unless the challenge is to the arbitration clause itself, the issue of the contract's validity is considered by the arbitrator in the first instance. Third, this arbitration law applies in state as well as federal courts.³⁰

In *McGuire v. Coolbrands Smoothies Franchise, LLC*³¹, the California appellate court upheld the trial court's refusal to compel arbitration after concluding that the arbitration provisions were procedurally and substantively unconscionable. The franchisor argued that the arbitrators must determine the validity and scope of provisions of the franchise agreement, other than the arbitration clause, because the plaintiff franchisees had not proven any unconscionability regarding the franchise's agreement's arbitration clause. The franchisees had asserted that appellate court should uphold the trial court's refusal to compel arbitration because the arbitration provisions were both procedurally and substantively unconscionable. The court noted that under California law, if a contract or clause therein is unconscionable at the time the parties entered into it, a court may refuse to enforce the contract, or it may enforce the contract without enforcing the unconscionable provision.³² The court held that the arbitration clause was unconscionable and therefore not enforceable. Hence, the franchisor could not compel arbitration of the dispute concerning non-arbitrable provisions of the franchise agreement.

Additionally, Section 1 of the FAA requires courts to place arbitration agreements on the same footing as other contracts.³³ Section 1 preempts state law "defenses that apply only to arbitration or that derive their meaning from the fact that an agreement to arbitrate is at issue."³⁴ For example, in *Awuah v. Coverall*, the United States District Court in Massachusetts adopted the view that arbitration clauses cannot be enforced unless there is heightened notice to the party sought to be bound. The First Circuit reversed, holding that not only is that not found in Massachusetts state law, but any principle of state law that conflicts with the FAA is preempted. Another example of preemption is of state law that prohibits the arbitration of certain disputes, such as franchise disputes.³⁵

²⁹ *Id.* at 444.

³⁰ *Id.* at 446.

³¹ Case No. H030202, 2007 WL 2381545 (Cal. App. 6 Dist. Aug. 22, 2007).

³² *Id.* at *7.

³³ *Awuah v. Coverall North America, Inc.*, 703 F.3d 36, 39 (1st Cir. 2012).

³⁴ *Id.* at 45-46 (citing *AT&T Mobility*, 131 S. Ct. 1740 at 1746).

³⁵ *Southland Corp. v. Keating*, 465 U.S. 1, 11-12 (1984) (Section 2 of the FAA preempted a provision of the California Franchise Investment Law that California courts had interpreted to require judicial consideration of claims arising under that law). Notwithstanding this holding, state law principles govern the validity of the agreements. Section 2 of the FAA permits arbitration agreements to be invalidated by generally applicable contract defenses, including unconscionability. *AT & T Mobility*, 131 S. Ct. 1740.

C. Who Can Be Required To Arbitrate?

The right to compel arbitration is a contractual right which is held by a party to an agreement. To enforce the arbitration agreement against an unwilling party, a signatory may demand that the court compel the parties to arbitrate pursuant to the agreement. However, this is more complex in a franchise context because a franchise relationship may be comprised of several agreements and parties, which presents various circumstances in which the right of signatories and non-signatories to arbitrate may be at issue. For instance, for one single franchise relationship, there may be a franchise agreement, guaranty agreement, license agreement, confidentiality agreement, and lease agreement, with different legal entities signing each respective agreement. Enforceability of arbitration agreements becomes even more complicated when master and sub-franchisees are involved.

1. Can Signatories Compel Non-signatories?

In *CD Partners, LLC*, the Eighth Circuit stated that a different test applies for determining whether a signatory can force a non-signatory into arbitration and whether a non-signatory can force a signatory into arbitration. The court stated:

[I]t matters whether the party resisting arbitration is a signatory or not.... [A] willing non-signatory seeking to arbitrate with a signatory that is unwilling may do so under what has been called an *alternative estoppel theory* which takes into consideration the relationships of persons, wrongs, and issues, [b]ut a willing signatory seeking to arbitrate with a non-signatory that is unwilling must establish at least one of the five theories described in [*Thomson–CSF, S.A. v. Am. Arbitration Ass'n*, 64 F.3d 773, 776 (2d Cir.1995)].³⁶

The five theories under which a non-signatory may be bound or benefited by an arbitration agreement are: 1) incorporation by reference; 2) assumption; 3) agency; 4) veil-piercing/alter ego; and 5) estoppel.³⁷ The Supreme Court and the majority of the United States Courts of Appeal recognize these five theories when enforcing an arbitration agreement against a non-signatory.³⁸ The most common theories used to compel an arbitration agreement against a non-signatory in a franchise relationships are promissory estoppel, incorporation by reference, and agency.

³⁶ 424 F.3d 795, 799 (8th Cir. 2005) (citing *Merrill Lynch Inv. Managers v. Optibase, Ltd.*, 337 F.3d 125, 131 (2d Cir. 2003).

³⁷ *Thomson-CSF, S.A. v. Am. Arbitration Ass'n*, 64 F.3d 773, 776 (2d Cir. 1995).

³⁸ See, e.g., *Arthur Andersen LLP v. Carlisle*, 556 U.S. 624, 631 (2009); *Crawford Prof'l Drugs, Inc. v. CVS Caremark Corp.*, 748 F.3d 249, 257 (5th Cir. 2014); *Zurich Am. Ins. Co. v. Watts Indus., Inc.*, 417 F.3d 682, 687 (7th Cir. 2005); *Denney v. BDO Seidman, L.L.P.*, 412 F.3d 58, 71 (2d Cir. 2005); *Trippe Mfg. Co. v. Niles Audio Corp.*, 401 F.3d 529, 532 (3d Cir. 2005); *Javitch v. First Union Securities, Inc.*, 315 F.3d 619, 628-29 (6th Cir. 2003); *Employers Ins. of Wausau v. Bright Metal Specialties*, 251 F.3d 1316, 1322 (11th Cir. 2001); *Int'l Paper Co. v. Schwabedissen Maschinen & Anlagen GMBH*, 206 F.3d 411, 416-17 (4th Cir. 2000).

a. Promissory Estoppel

The doctrine of promissory estoppel in the arbitration context recognizes “that a party may be estopped from asserting that the lack of his signature on a written contract precludes enforcement of the contract’s arbitration clause when he has consistently maintained that other provisions of the same contract should be enforced to benefit him.”³⁹ Basically, a non-signatory is estopped from refusing to comply with an arbitration clause when it receives a direct benefit from the underlying agreement.⁴⁰ “To allow [a plaintiff] to claim the benefit of the contract and simultaneously avoid its burdens would both disregard equity and contravene the purposes underlying enactment of the Arbitration Act.”⁴¹

i. Direct Benefit Under the Agreement

A court may not enforce an arbitration provision using promissory estoppel against a non-signatory unless the non-signatory derives a direct benefit from the agreement. For example, in *Everett v. Paul Davis Restoration, Inc.*, franchisor PDRI submitted claims to arbitration against the franchisee, guarantor, and his wife for breach of the Franchise Agreement.⁴² Seeking to vacate the arbitration award, the wife alleged she was not bound to the arbitration and non-compete provisions in the Franchise Agreement because she was not a signatory. The wife also alleged that the franchisor failed to plead how she benefited from the agreement. The Franchisor argued that the wife was bound by the Franchise Agreement as a non-signatory under the doctrine of promissory estoppel: “Under this doctrine, ‘[a] non[-] signatory party is estopped from avoiding arbitration if it knowingly seeks the benefits of the contract containing the arbitration clause....’ [But,] “the benefit must be direct—which is to say, flowing directly from the agreement.”⁴³ The Court recognized that there was abundant evidence that the wife received a direct benefit from the Franchise Agreement—family owned business from which she profited. Additionally, the Franchisor argued that the wife’s competing business would not exist but for the Franchise Agreement. However, the Court reiterated that the Franchisor needed to show that the wife benefited *directly* from the *franchise agreement*, not the business that the contract made profitable.⁴⁴ The Court explained:

Here, Ms. Everett exploited, or benefitted from, the contractual relationship her husband and EAGB had with [the Franchisor]. EAGB presumably was profitable because of the [Franchise Agreement]. As Matt’s spouse and co-owner of EAGB, Ms. Everett had a right to share in the profits. But this benefit was indirect; it

³⁹ *Int’l Paper Co.*, 206 F.3d at 418.

⁴⁰ *Am. Bureau of Shipping v. Tencara Shipyard S.P.A.*, 170 F.3d 349, 353 (2d Cir.1999).

⁴¹ *Int’l Paper*, 206 F.3d at 418 (citing *Avila Group, Inc. v. Norma J. of California*, 426 F. Supp. 537, 542 (S.D.N.Y.1977)).

⁴² 10-C-634, 2012 WL 4128016 (E.D. Wis. Sept. 18, 2012), *reconsideration denied*, 10-C-634, 2012 WL 6184993 (E.D. Wis. Dec. 11, 2012).

⁴³ *Id.* at *5 (internal citations omitted).

⁴⁴ *Id.* at *7.

derived from her ownership interest in EAGB and/or her marriage, not directly from the Franchise Agreement. This is not the kind of benefit that would bind her to the Franchise Agreement. Otherwise, [the Franchisor] would have no reason to have the owner of the legal entity operating the franchise separately sign the Franchise Agreement in his individual capacity....Absent evidence that the non[-]signatory directly benefitted from the agreement, “a signatory may not estop a non[-]signatory from avoiding arbitration regardless of how closely affiliated that non[-]signatory is with another signing party.”⁴⁵

This case illustrates the principle that in order to compel a non-signatory to arbitrate under the theory of estoppel, one must show the non-signatory received a *direct benefit* from the agreement itself. Consistent therewith, the Court in *Everett* stated if the wife personally brought a suit for wrongful termination under the Franchise Agreement, the franchisor would have been entitled to submit her claim to arbitration.⁴⁶

In *Binder v. Med Shoppe Int'l*,⁴⁷ Plaintiffs filed suit for breach of contract, and Medicine Shoppe International (“MSI”) moved to compel arbitration of plaintiff’s claims. Plaintiffs had entered into a license agreement to operate a Medicine Shoppe in Michigan. The license agreement provided that “all controversies, disputes or claims” between MSI and B&S (signatory to license agreement) must be submitted to arbitration. The two individual plaintiffs (“individuals”) executed a Guaranty and Assumption of Licensee’s Obligations (“Guaranty”), pursuant to which they agreed to be bound by the License Agreement.

The individuals claimed they were not required to personally submit to arbitration under the terms of their Guaranty. The Court disagreed and held that the Sixth Circuit recognizes that non-signatories may be bound to an arbitration agreement under ordinary contract and agency principles.⁴⁸ The court explained that the Guaranty “leaves no doubt as to its purpose and effect. In signing this document, [the individuals] agreed to be ‘personally ... bound by, and personally liable for breach of, each and every provision’ in the License Agreement.”⁴⁹ The Court further found that the individuals were also bound under an estoppel theory since this theory arises when a non-signatory “who obtains a direct contractual benefit seeks to disavow the agreement’s arbitration clause.”⁵⁰ The benefit derived by the individuals, as clearly stated in the Guaranty itself, was that the Guaranty served as consideration and inducement for MSI to sign the License Agreement. The Court found that this direct benefit estopped the individuals from disclaiming the obligation to arbitrate their claims.⁵¹

⁴⁵ *Id.* at *7 (citation omitted).

⁴⁶ *Id.* at *8.

⁴⁷ No. 09-14046, 2010 WL 2854308 (E.D. Mich. July 20, 2010).

⁴⁸ *Id.* at *6.

⁴⁹ *Id.*

⁵⁰ *Id.*

⁵¹ On the merits, the Court held that the License Agreement was voidable, “but only to the extent it require[d] arbitration to take place in...Missouri.” *Id.* at 9.

In *Mac Tools v. Diaz*,⁵² the doctrine of equitable estoppel and the “intertwining” of claims required a non-signatory wife to arbitrate her claims against the manufacturer pursuant to a professional-grade tools distribution agreement her husband entered into. The non-signatory wife filed an action against the manufacturer in New Jersey state court as an investor in the distributing company solely owned by her husband. The manufacturer removed the case to federal court and filed a motion to compel arbitration of the claims of both the wife and her husband pursuant to the distribution agreement. The parties disputed whether the wife was required to arbitrate her claims as a non-signatory to the agreement. The manufacturer argued that the wife was estopped from avoiding the arbitration clause since her claims sought a direct benefit under the agreement, and further because she availed herself of the dispute resolution procedures contained within the agreement.⁵³ The wife argued that the manufacturer could not show that her claims were “inextricably intertwined” with her husband’s claims to render her claim subject to arbitration.⁵⁴ The Court agreed with the manufacturer and stated that when an “indirect benefit” is sought “it is only a signatory that may be estopped from avoiding arbitration with a non-signatory when the issues the non-signatory is seeking to resolve in arbitration are intertwined with the underlying contract.”⁵⁵ Additionally, the wife’s claims were that the manufacturer fraudulently induced her into acquiring the business; therefore, it was clear that she intended to seek a benefit under her husband’s agreement and treated the purchase of the distributorship as a collective acquisition.⁵⁶

Further, in *Kairy v. SuperShuttle Int’l, Inc.*,⁵⁷ Kairy and a group of airport shuttle franchises brought suit against SuperShuttle for violation of the Fair Labor Standards Act (“FLSA”) and California law. SuperShuttle moved to compel arbitration and to stay the action pursuant to the underlying franchise agreements. Plaintiffs unsuccessfully opposed the motion to compel by arguing that statutory claims, such as those under the FLSA, are properly resolved through legal proceedings and that some of the plaintiffs, who were secondary drivers, were not signatories to the franchise agreement and so could not be compelled to arbitrate.⁵⁸

The Court rejected plaintiffs’ statutory claim. The Court cited to *AT&T Mobility LLC v. Concepcion*⁵⁹ which held that arbitration agreements may not be invalidated “by defenses that only apply to arbitration or derive their meaning from the fact that an agreement to arbitrate is at

⁵² 2:11-CV-940, 2012 WL 1409395 (S.D. Ohio Apr. 23, 2012).

⁵³ *Id.* at *5.

⁵⁴ *Id.*

⁵⁵ *Id.* (citing *Int’l Paper Co. v. Schwabedissen Maschinen & Anlagen GMBH*, 206 F.3d 411, 418 (4th Cir. 2000)).

⁵⁶ *Id.*

⁵⁷ Case No. 08-02993, Bus. Franchise Guide (CCH) ¶ 14, 927 (N.D. Cal Sept. 20, 2012).

⁵⁸ *Id.* at *3.

⁵⁹ 131 S. Ct. 1740 (2011).

issue.”⁶⁰ Further, the Court found that an arbitration agreement excluding class-wide arbitration is no longer considered unconscionable.⁶¹

Next, the Court held that the secondary drivers, who were non-signatories to the arbitration agreement, were bound by the mandatory arbitration clause in that contract. The Court noted that the doctrine of estoppel precludes a party from claiming benefits of a contract while simultaneously attempting to avoid the burdens the contract imposes.⁶² Additionally, the Court observed that “non-signatories can be held to arbitration clauses where the non-[signatory] ‘knowingly exploits the agreement containing the arbitration clause despite having never signed the agreement.’”⁶³ The Court found it clear, from both the Plaintiffs’ claims and the specific language of the franchise agreements, that the non-signatories knowingly exploited their rights and privileges granted by the agreements by making claims that required that they participate actively under the rights and duties specified in the franchise agreements.⁶⁴ In conclusion, the Court held “[a]s intended third party beneficiaries of the contracts..., the secondary drivers have the right to enforce the agreements as well as the benefits of being bound by the arbitration provision the agreements contain.”⁶⁵

b. Incorporation by Reference

Another commonly used theory to bind a non-signatory to an arbitration clause is incorporation by reference. A non-signatory may be bound by a franchise agreement that contains an arbitration clause if a separate agreement was entered by the non-signatory that incorporates the other by reference.

In *Upstate Shredding, LLC v. Carlross Well Supply Co.*, the Court stated that determining the applicability of the “incorporate by reference” doctrine is a two-step process.⁶⁶ First, the court must determine whether the agreement contains the requisite words of incorporation. Second, the court must determine whether the arbitration clause is broad enough to encompass the non-signatory and the concurrent controversy.⁶⁷ Courts can even incorporate an arbitration agreement by reference if the relevant incorporation language does not specifically refer to the arbitration provision.⁶⁸ For example, an ancillary contract can incorporate by reference the

⁶⁰ *Id.* at 1746.

⁶¹ *Id.*

⁶² *Id.* at *8 (citing *Washington Mutual Fin. Group, LLC v. Bailey*, 364 F.3d 260, 267 (5th Cir. 2004)).

⁶³ *Id.*

⁶⁴ The FLSA and Labor Code require that the secondary drivers specifically perform under the contract. *Id.*

⁶⁵ *Id.* See also Section II-C-2-b (cases concerning non-signatory third party beneficiaries compelling signatories to arbitrate with them).

⁶⁶ 84 F. Supp. 2d 357, 365-66 (N.D.N.Y. 2000).

⁶⁷ *Id.*; Dwayne E. Williams, *Binding Nonsignatories to Arbitration Agreements*, 25 Franchise L.J. 175, 176 (2006).

⁶⁸ *World Rentals & Sales, LLC v. Volvo Const. Equip. Rents, Inc.*, 517 F.3d 1240, 1245 (11th Cir. 2008).

“general conditions” of the other contract (one of which contains the requirement to arbitrate), even though the incorporation provision does not specifically mention the arbitration clause.⁶⁹

In *World Rental & Sales*, the Eleventh Circuit found that the unambiguous language in loan documents incorporated by reference the arbitration clause found in the franchise agreement. However, the Court found that the arbitration provision itself was not broad enough to cover the current controversy.⁷⁰ Volvo Finance’s counterclaim against World Rental relied on its failure to make timely payments under the loan documents. Therefore, the claims did not relate to the Franchise Agreement, which contained the arbitration clause.⁷¹

Likewise, in *Gingiss Int’l, Inc. v. Bormet*, a franchisees’ shareholders and officers sought to avoid an arbitration agreement by arguing they were non-signatories to the Franchise Agreement.⁷² The Seventh Circuit compelled arbitration because the Shareholders’ and Officers’ Agreement incorporated the Franchise Agreement’s arbitration clause. Challenging the scope of the arbitration provision, the shareholders and officers argued that the arbitrator had no jurisdiction over the Lanham Act claims.⁷³ The scope of the arbitration provision provided in pertinent part, “all disputes and claims relating to any provision’ of the franchise agreement [were] subject to arbitration unless [franchisor] elected to pursue certain claims set forth in the agreement in a judicial forum, including Lanham Act claims.”⁷⁴ The Court found that this language of the Franchise Agreement provided the franchisor with the right, but not the obligation, to litigate the Lanham Act claims rather than submit them to arbitration.⁷⁵ Therefore, the shareholders and officers were required to submit to arbitration.

Although incorporation by reference is commonly used by signatories to compel arbitration against non-signatories, non-signatories also have used this theory to compel arbitration against signatories. In *Synergistic Int’l, LLC v. Monaghan*, the franchise agreement at issue contained a provision that mandated mediation, and then arbitration, of “any controversy or claim arising out of or relating to [the] Agreement or the breach thereof or any transaction embodied therein or related thereto.”⁷⁶ However, the franchise agreement also provided an exception to mediation/arbitration for “emergency relief” relating to the franchisor’s marks or a situation in which the franchisor would otherwise suffer irreparable loss or damage. The individual owner and guarantor of the franchised location, Michael Monaghan (“owner”), also entered into a Confidentiality Agreement that contained a non-compete clause. However, the Confidentiality Agreement did not include a specific provision mandating mediation/arbitration.

⁶⁹ *Id.*

⁷⁰ *Id.*

⁷¹ *Id.* at 1248.

⁷² 58 F.3d 328, 331-32 (7th Cir. 1995).

⁷³ *Id.*

⁷⁴ *Id.* at 332.

⁷⁵ *Id.*

⁷⁶ Case No.12-3299, 2013 WL 5587269, at *3 (C.D. Ill. Oct. 10, 2013).

After termination of the franchise agreement, the franchisee and owner opened and operated a new competing location. As a result, the franchisor filed a nine-count complaint against the former franchisee, individual owner, guarantor, the guarantor's spouse, and the franchisee's new business entity. The franchisee moved to compel mediation/arbitration pursuant to the franchise agreement. The franchisor opposed the motion by arguing that since the claims related to the franchisor's marks, all nine counts of the complaint were properly before the court. The Court, applying the exception for "emergency relief" clause, denied the demand for arbitration. The Court held that since Monaghan was not a party to the Franchise Agreement and since the Confidentiality Agreement did not contain a provision requiring mediation/arbitration, plaintiff's count for breach of the confidentiality agreement was not subject to the alternative dispute clause.⁷⁷ The reasoning of this opinion has been criticized by certain commentators, however, because it runs afoul of the FAA's embodiment of a liberal federal policy favoring arbitration agreements.⁷⁸

c. Agency

Contract principles of agency law may bind principals to arbitration agreements, and in some cases, bind agents to agreements they signed on behalf of their principals.⁷⁹ Additionally, a non-signatory may be compelled to arbitrate whether a non-signatory "dominated" a signatory (an appropriate issue in determining whether to pierce the signatory's corporate veil).⁸⁰ "However, the requirements for such vicarious responsibility are exacting. Not only must an agency relationship exist, but the relationship must be relevant to the legal obligation in dispute. The agent must have been acting within the scope of the agency relationship when he signed the contract on behalf of the principal."⁸¹ Additionally, a signatory is entitled to a presumption of independence. Therefore, the party seeking to bind a principal has the burden to prove that the signatory signed the agreement as an agent.⁸²

For example, in *Embroidme.Com, Inc. v. Am. Design Studios, Inc. & IDT Worldwide, Inc.*,⁸³ plaintiff, an embroidery business franchisor ("IDT"), and defendant American Design Studios ("ADS"), a shirt manufacturer, entered into a settlement agreement as a result of an arbitration demand filed by ADS for payments past due. However, IDT, ADS' parent company, was not a signatory to the settlement agreement. After plaintiff made a demand for arbitration to enforce the terms of the settlement agreement, both IDT and ADS failed to appear, and the arbitrator entered an award against them. IDT claimed that since it was not a signatory to the settlement agreement, IDT was not required to arbitrate. The court determined that the arbitrator properly concluded IDT clearly and unmistakably agreed to arbitration since the parties

⁷⁷ *Id.* at *7.

⁷⁸ *AT&T Mobility LLC v. Concepcion*, 131 S. Ct. 1740 (2011).

⁷⁹ Williams, *supra* n. 67, 25 Franchise L.J. at 177.

⁸⁰ *World Rental & Sales, LLC v. Volvo Construction Equip. Rents, Inc.*, 517 F.3d1240, 1247-48 (11th Cir. 2008).

⁸¹ *Id.* (internal citations omitted).

⁸² Williams, *supra* n. 67, 25 Franchise L.J. at 177.

⁸³ Case No. 10-81180, Bus. Franchise Guide (CCH) ¶ 14, 631 (S.D. Fla. July 5, 2011).

designated the AAA as governing any dispute⁸⁴ and the parent company had waived any objection to the arbitrator's jurisdiction by participating in the arbitration. Additionally, the franchisor established that ADS was the agent of IDT.⁸⁵

Additionally, in *World Rental & Sales, LLC*, the court notes that a "non-signatory may be compelled to arbitrate under an agency theory if a signatory signed the arbitration agreement as the non-signatory's agent....Likewise, a non-signatory may be compelled to arbitrate if it so dominated a signatory that it is appropriate to pierce the signatory's corporate veil and hold the non-signatory liable on the contract containing the arbitration provision."⁸⁶

In *Willamette Crest Gaming, LLC v. Play N Trade Franchise, Inc.*, two individuals signed a franchise agreement as principals of the franchisee entity.⁸⁷ The individuals sought to avoid the arbitration clause contained in the franchise agreement on the ground that they were non-signatories to the agreement. The Court found that even if they did not sign as individuals, the franchise agreement itself clearly made them parties to the agreement.⁸⁸ Thus, the franchise agreement provided that it was "made and entered into...by and between...[franchisor], [franchisee]...and each person owning 20% or more of Franchisee who will be a party to this Agreement..."⁸⁹ Additionally, another provision provided that each principal agreed to be bound, individually and jointly, by all provisions of the agreement. The Court concluded that, therefore, the arbitration provision specifically bound the individuals.

Defendant Franchisor also argued that even if the franchise agreement did not control, the individuals were bound as agents and principals of the Franchisee. The court found that individuals' claims of misrepresentation related to the disclosures required by law to be made by a franchisor to a franchisee. The court explained that to the extent the individuals relied upon misrepresentations, they did so as agents of the Franchisee. Therefore, the court held that the individual's claims were derivative of the Franchisee's claim and they had to be brought in arbitration.⁹⁰

2. Can Non-Signatories Compel Signatories To Arbitrate With Non-Signatories?

a. In General

Signatories to an arbitration agreement sometimes seek to avoid submitting their claims to arbitration. One tactic employed to attempt to achieve this end is adding as parties to the

⁸⁴ *Id.* at 5.

⁸⁵ *Id.*

⁸⁶ 517 F.3d at 1247-1248.

⁸⁷ CIV. 09-461-ST, 2009 WL 2243811 (D. Or. July 27, 2009).

⁸⁸ *Id.* at *9.

⁸⁹ *Id.*

⁹⁰ *Id.*

lawsuit non-signatory persons or entities that are closely related to the signatories to the arbitration agreement. However, when the claims against the non-signatories are closely related to the underlying contract containing the arbitration clause, these other non-signatories sometimes can compel arbitration against the signatories to the agreement. In the franchise context, this often occurs with parent companies, subsidiaries, officers and directors, spouses, agents, employees, insurers, guarantors, and newly created competing entities. In most cases, courts find that the mere presence of parties not subject to an arbitration provision does not prevent a court from compelling a signatory to an arbitration provision to arbitrate.⁹¹

Likewise, one does not have to be a signatory to an arbitration clause in order to invoke the benefits or rights under such clause,⁹² and this is true even when a party seeks to impose an arbitration obligation upon a non-signatory.⁹³ Because the ability of a non-signatory to enforce arbitration agreements against signatories is determined by state contract law, drafters and litigants need to be aware of the varying state laws on enforcement of arbitration agreements.⁹⁴

In *CD Partners, LLC v. Grizzle*, non-signatory officers of a corporate franchisor enforced an arbitration clause contained in a franchise agreement against the plaintiff franchisee, who was a signatory to the agreement.⁹⁵ The franchisee brought tort claims against the officers of the franchisor in state court, and the non-signatory officers moved to compel arbitration. In opposing the motion, franchisee alleged that the non-signatory officers could not enforce the arbitration provision because they were not signatories and, in any event, the tort claims did not fall within the scope of the arbitration clauses. Rejecting this argument, the court held that franchisee's claim relied upon and referred to the existence of the franchise agreement, so arbitration was appropriate.⁹⁶ Secondly, the court considered the language of the arbitration clause contained in the franchise agreement, finding the language was broad and not restricted to disputes between parties, but applied to "any claim, controversy or dispute arising out of or relating to Franchisee's operation of the Franchised business..."⁹⁷ Therefore, the Court held these provisions conferred the benefit of the agreement on the franchisor's officers, who were entitled to compel arbitration.

⁹¹ See, e.g., *Moses H. Cone Mem'l Hosp. v. Mercury Const. Corp.*, 460 U.S. 1, 20 (1983); *J & K Cement Const., Inc. v. Montalbano Builders, Inc.*, 456 N.E.2d 889, 900-01 (Ill. App. Ct. 1983).

⁹² *Int'l Paper Co. v. Schwabedissen Maschinen & Anlagen GMBH*, 206 F.3d 411 (4th Cir. 2000).

⁹³ *Jones v. Genus Credit Mgmt. Corp.*, 353 F. Supp. 2d 598 (D.Md. 2005)(non-signatory to arbitration agreement may enforce or be bound by the agreement's terms).

⁹⁴ *Torres v. Simpatico, Inc.*, 4:12CV2373 CDP, 2014 WL 409157 (E.D. Mo. Feb. 3, 2014) (citing *Donaldson Co. Inc. v. Burroughs Diesel, Inc.*, 581 F.3d 726, 732 (8th Cir. 2009)).

⁹⁵ 424 F.3d 795 (8th Cir. 2005).

⁹⁶ *Id.* at 798 (internal citations omitted).

⁹⁷ *Id.* at 797.

b. Third Party Beneficiaries

Courts allow non-signatory intended third-party beneficiaries to compel arbitration against signatories of arbitration agreements, provided that the claims arise from an agreement that contains an arbitration provision.⁹⁸ The contract must evidence a clear intent to benefit the party, however.

For example, in *Torres v. Simpatico*, non-signatory third party beneficiaries were able to enforce the terms of a contract where the contract clearly expressed an intent to benefit a party or “an identifiable class of which the party is a member.”⁹⁹ The unit franchisees/plaintiffs brought a RICO class action against Stratus franchising, its officers, three individual master franchisees (which were signatories to the agreement), and a number of other master franchisees that did not contract with plaintiffs.¹⁰⁰ The Court found that the franchisor and the non-signatory master franchisees were intended third party beneficiaries of the unit franchise agreement because the agreement recited that “it is intended to benefit and bind certain third party non-signatories...” The agreement required the unit franchisees to purchase insurance policies naming the franchisor as an additional insured and to provide for the indemnity of “Stratus and other franchisees.”¹⁰¹ Therefore, the Court held that because the agreement reflected the signee’s intent to benefit some third parties and the unit franchise agreement conferred benefits upon master franchisees, the non-signatory parties could enforce the arbitration clause of the agreement against the signatories.

In *Collins v. Int’l Dairy Queen, Inc.*, franchisees and subfranchisees filed a class action lawsuit against American Dairy Queen Corporation (“ADQ”) and its parent corporation (“IDQ”).¹⁰² The class consisted of franchisees that directly contracted with ADQ and subfranchisees that contracted with master franchisees to which ADQ granted the authority to sublicense their territories. However, ADQ and IDQ were non-signatories to the subfranchise agreements between the Territory operators and those subfranchisees. In the first proceeding, the Court held that IDQ was entitled to rely on the arbitration provisions contained in agreements between ADQ and plaintiffs. The court explained that, “[w]hen the charges against a parent company and its subsidiary are based on the same facts and are inherently inseparable, a court may refer claims against the parent to arbitration even though the parent is not formally a party to the arbitration agreement....The claims against the two entities are based on essentially the same facts and are in the court’s view inherently inseparable.”¹⁰³ The Court held that parent corporation IDQ was therefore entitled to rely upon the mandatory arbitration provision contained in the franchise agreement to which only ADQ was a signatory.¹⁰⁴ However,

⁹⁸ Williams, *supra* n 67, 25 Franchise L.J. at 178 (2006). An alternative holding of *Kairy v. Supershuttle*, Case No. 08-02993, Bus. Franchise Guide (CCH) ¶ 14, 927 (N.D. Cal Sept. 20, 2012), discussed earlier (see n. 57 and accompanying text), rested on this theory.

⁹⁹ 4:12CV2373 CDP, 2014 WL 409157 at *5 (E.D. Mo. Feb. 3, 2014).

¹⁰⁰ *Id.* at *3.

¹⁰¹ *Id.* at *5.

¹⁰² 169 F.R.D. 690 (M.D. Ga. 1997)(“*Collins I*”).

¹⁰³ *Id.* at 692-93.

neither IDQ nor ADQ were able to rely on the arbitration provisions contained in the subfranchisee agreements because the provisions were only applicable to master franchisees.

In the second proceeding, the Court granted in part IDQ's motion to stay certain subfranchisees' claims based on the specific language of certain subfranchise and master franchise agreements.¹⁰⁵ IDQ and ADQ argued that they were third-party beneficiaries of the subfranchise agreements and, therefore, were entitled to invoke the arbitration clauses of those agreements.¹⁰⁶ In deciding this issue, the court first noted that the arbitration provisions at issue were not specifically made applicable to disputes which may arise with IDQ and ADQ. The arbitration provision in one form of subfranchise agreement provided: "*In the event of any dispute between the parties hereto arising under, out of, in connection with or in relation to this Agreement, said dispute shall be submitted by the parties to binding arbitration in accordance with the Rules and Procedures and under the auspices of the American Arbitration Association.*"¹⁰⁷ However, another form agreement provided for arbitration of "any dispute between *Territory Operator and Licensee* arising under, out of, in connection with or in relation to this agreement," while still other agreements required arbitration "in the event of a breach of threatened breach ... by *Licensee*."¹⁰⁸

The court found numerous factors supporting third-party beneficiary status for the defendants. Subfranchisees were required to operate their agreements according to specifications of ADQ, required to use Dairy Queen Marks, and contract approval was required by ADQ. Therefore, the "writing itself demonstrate[d] that defendants [were] third-party beneficiaries of the subfranchise agreements and that the subfranchisees by signing the agreements intended to bestow numerous benefits on defendants."¹⁰⁹ On the other hand, as to those subfranchisee agreements that limited arbitration to disputes between "Territory Operator and Licensee," defendants could not compel arbitration, since it was clear there was no intent for arbitration provisions to apply, notwithstanding their third-beneficiary status.¹¹⁰

4. Drafting Considerations

Drafters of franchise agreements should keep the above principles of contract and agency law in mind, together with varying state law, while drafting the variety of agreements that govern a franchise relationship. As many of the cases make clear, careful drafting can essentially determine the forum of a case or even prevent certification of a plaintiff class altogether. For instance, in *Dairy Queen*, if all the subfranchisee agreements had contained broad and uniform language providing the parent and subsidiary companies a right to compel

¹⁰⁴ *Id.*

¹⁰⁵ Williams, *supra* n. 67, 25 Franchise L.J. at 178.

¹⁰⁶ *Collins v. Int'l Dairy Queen, Inc.*, 2 F. Supp. 2d 1465, 1467 (M.D. Ga. 1998) ("*Collins II*").

¹⁰⁷ *Id.* at 1468.

¹⁰⁸ *Id.*

¹⁰⁹ *Id.*

¹¹⁰ *Id.*

arbitration, defendants may have prevented the certification of a plaintiff class altogether.¹¹¹ Consistency amongst all the agreements governing the franchise relationship is also important. In *Dairy Queen*, astonishingly, there were approximately 360 different versions of the subfranchisee agreements used system-wide.¹¹² Some of the forms contained broad language applying to any dispute, and some limited arbitration “in the event of a breach of threatened breach...by licensee.”¹¹³ This varying language required some claims to be submitted to arbitration while others, not subject to a narrowly drafted arbitration clause, proceeded in court.

Below are drafting considerations to keep in mind to prevent, or at least limit, litigation over the enforceability of arbitration provisions with unwilling signatories and non-signatories.

a. Designate the State Law

Because state law principles govern the validity of arbitration agreements, it is important to designate which state law applies. Additionally, Section 2 of the FAA permits arbitration agreements to be invalidated by generally applicable contract defenses, including unconscionability.¹¹⁴

b. Obtain Spousal Consent

Issues may arise with enforcing arbitration agreements against non-signatory spouses or someone else with a close relationship to a signatory. The first can be avoided easily by obtaining spousal consent at the time of executing the documents governing the franchise relationship. Further, arbitration provisions can be enforced against a non-signatory when there is a pre-existing relationship between the non-signatory and one of the parties to the arbitration agreement, which makes it equitable to compel the non-signatory to arbitration. “Examples of this pre-existing relationship include agency, spousal relationship, parent-child relationship, and the relationship of a general partner to a limited partnership.”¹¹⁵ Spousal consent can be beneficial for drafters of agreements that govern franchise relationships, to make clear what terms of the agreements will be enforced both during and after the franchise relationship by the franchisor against the non-franchisee spouse.¹¹⁶

c. Incorporation by Reference and Third Party Beneficiaries

Given the sheer number of agreements governing a franchise relationship, the absence of an arbitration provision from some of the agreements, or varying language and definitions,

¹¹¹ Williams, *supra* n. 67, 25 Franchise L.J. at 181.

¹¹² Collins I, 169 F.R.D. at 692.

¹¹³ *Id.*

¹¹⁴ *AT&T Mobility LLC v. Concepcion*, 131 S. Ct. 1740 (2011).

¹¹⁵ *Crowley Mar. Corp. v. Boston Old Colony Ins. Co.*, 158 Cal. App. 4th 1061, 1070, 70 Cal. Rptr. 3d 605, 611 (2008) (citing *Matthau v. Superior Court*, 151 Cal. App. 4th 593, 599, 60 Cal. Rptr. 3d 93, 97 (2007)); see Giller, Garner and Sheps, *Yours, Mine, Ours, and Theirs: The Role of Spousal Guaranties and Consents in the Franchise Relationship*, 33 Franchise L.J. 77 (2013).

¹¹⁶ Giller, Garner and Sheps, *supra* n. 115.

are common. Issues arising from the absence of an arbitration provision can be avoided by having a broad integration clause to cover the various individuals who are signatories to the ancillary agreements.

Courts can infer also that the parties intended to incorporate an arbitration agreement by reference through examination of the other language contained in the agreement. Precise language may not be the *sine qua non*. For example, the First Circuit has held that traditional magic words “incorporating by reference” the arbitration clause in a franchise agreement were not required.¹¹⁷ Instead, the Court found that other language in the transfer agreements clearly communicated the purpose of incorporating the arbitration clause: Since the arbitration clause of the franchise agreement “creates a right and an obligation to submit ‘all controversies, disputes or claims between [Franchisor]...and Franchisee’ to arbitration, the Transfer Agreements sufficiently incorporated by reference the arbitration clause. Because the law varies state-to-state, drafters should utilize the “magic words” if possible so that the arbitration clause is incorporated by specific reference.¹¹⁸

Additionally, to allow officers, agents, parents or subsidiaries, and any other third-party beneficiary to the contract, the ability to compel arbitration pursuant to the agreement, one should provide language that evidences a clear intent to benefit those third parties. For example, in *Torres v. Simpatico, Inc.*, the language “it is intended to benefit and bind certain third party non-signatories,”¹¹⁹ allowed non-signatories, franchisor and master franchisees to compel arbitration. If the language is not broad enough, notwithstanding third-party beneficiary status, parties may not enforce the arbitration clause.¹²⁰ For example, the Torres case also observed that the language “any dispute between Territory operator and licensee,” was insufficient to permit the franchisor and master franchisee from compelling arbitration.

d. Use Broadly Worded Provisions

In order to ensure that an arbitration clause is broad enough to apply to non-signatories, drafters should write the arbitration provisions broadly and clearly enough so a court can make a determination whether or not the arbitration clause at issue applies to the parties. As shown by *Upstate Shredding*, limiting an arbitration provision to “disputes between parties” where the parties are specifically identified in the agreement would exclude non-signatories to the agreement.¹²¹ Additionally, drafters should avoid restrictive language, and instead use broader standard terms such as “arise out of” and “in connection with.”¹²²

¹¹⁷ *Awuah v. Coverall N. Am., Inc.*, 703 F.3d 36, 43 (1st Cir. 2012).

¹¹⁸ *Williams*, *supra* n. 67, 25 Franchise L.J. at 176-77.

¹¹⁹ *Torres v. Simpatico, Inc.*, 4:12CV2373 CDP, 2014 WL 409157 at *5 (E.D. Mo. Feb. 3, 2014).

¹²⁰ *Id.*

¹²¹ *Upstate Shredding, LLC v. Carlross Well Supply Co.*, 84 F. Supp. 2d 357, 367 (N.D.N.Y. 2000).

¹²² *Id.*

III. ENFORCING COVENANTS NOT TO COMPETE AGAINST NON-SIGNATORIES

Parties to an agreement are not the only ones who can be required to comply with the terms of a non-compete. Covenants not to compete in the context of a franchise agreement sometimes defy traditional notions of contract law. Virtually all franchise agreements contain provisions that restrict a party's ability to compete with the corresponding franchise system during the term of the franchise agreement, and the vast majority contain such a restriction lasting for some time following the voluntary or involuntary termination or expiration of the franchise agreement. Thus, if a franchisee¹²³ operates a new business venture in direct competition with the franchise system and in violation of the non-compete, a franchisor seeking to enforce the terms of its agreement should be able to prove easily that the franchisee breached the terms of the franchise agreement.

Sometimes, however, the franchisee's involvement is covert and not readily apparent. Franchisees may attempt to circumvent the terms of the non-compete by finding creative ways to participate in a business that competes with the franchise system, or uses confidential knowledge and experience gained during the operation of the franchise, for a separate business venture. This may entail the involvement of the franchisee's relative, friend, or business associate who was a stranger to the franchise agreement and, hence, is not expressly bound to the terms of the covenant not to compete. In this instance, the franchisee may not be in the clear and the franchisor may still have some recourse to enforce the covenant not to compete against third parties.

To be sure, ordinarily, only parties to an agreement are bound by the covenants of a contract. However, under certain circumstances a non-signatory can also be bound by a covenant not to compete contained in a franchise agreement, even though that person was not a party to the agreement. An analysis of this important concept requires balancing the competing interests involved.¹²⁴ A non-party may conduct herself or himself in a manner that arguably violates the terms of a non-compete designed to protect the franchise system. But, should a non-party be bound by an agreement the person did not sign? Technically, there is no breach of contract because the non-signatory was not a party to the agreement in the first place. When the non-signatory acts in a manner that aids, assists or constitutes an active participation in the breach of the non-compete, however, the franchisor has some legal recourse against the third-party. While the non-signatory may obviously have a substantial interest in not being bound to the terms of an agreement to which it was not a party, such an interest must be balanced against the interest of a franchisor to protect its system, name, brand, operations, intellectual property, and—in essence—its business.

¹²³ For the sake of brevity, unless otherwise noted, references to "franchisees" in this section refer to both current and former franchisees.

¹²⁴ For additional in-depth discussions of the enforceability of non-competes against non-signatories, see Michael R. Gray and Jason M. Murray, *Covenants Not to Compete and Nonsignatories: Enjoining Unfair Conspiracies*, 25 Franchise L.J. 107 (2006) and Emma Cano and Katie Dolan-Galaviz, *If it Looks Like a Duck, Walks Like a Duck, and Quacks Like a Duck: The Enforceability of Noncompetes Against Nonsignatories*, 33 Franchise L.J. 543 (2014).

Equitable principles have often led courts to enforce covenants not to compete against third parties who assist, aid or conspire with the franchisee in circumventing the contractual obligations mandated by the franchise agreement. Furthermore, courts sometimes find that the non-signatory was so connected to the former franchise that it would be inequitable to permit the non-signatory to continue the business venture in violation of the non-compete. Thus, franchisees cannot implicate third-parties in schemes aimed at avoiding the contractual terms of the franchise agreement and assume they will escape the long arm of the law.

A. The Seminal Case of *McCart v. H&R Block, Inc.*¹²⁵

One of the leading cases involving the enforcement of a covenant not to compete against a non-signatory to a franchise agreement is *McCart v. H&R Block, Inc.*¹²⁶ *McCart* involved an H&R Block tax preparation business operated by Robert McCart (“Robert”). In 1968, after approximately one year of operating the H&R Block franchise, Robert accepted a position as H&R Block’s district manager. Because the new position with H&R Block precluded him from retaining the H&R Block franchise in his name, he transferred the franchise to his wife, June McCart (“June”). Several years later, June entered into a new franchise agreement with H&R Block and the franchise continued in existence for another six years. The new franchise agreement contained a covenant not to compete which restricted June’s ability to compete with H&R Block.

For nearly the last two years of the franchise’s existence, Robert (who was no longer employed by the franchisor) worked at the location of June’s franchise, performing management tasks, preparing tax returns for H&R Block customers, and participating in H&R Block meetings. During that same period, Robert also operated an accounting business separate from the H&R Block franchise.

In 1981, after twelve years of operating the franchise and within weeks of picking up supplies ordered from H&R Block in preparation for the upcoming tax season, June notified H&R Block’s district manager that, due to her arthritic condition, she would be unable to continue operating the H&R Block franchise. Shortly thereafter, June sent her H&R Block clients a letter notifying them of her decision to “dissociate” [sic] herself from H&R Block. The letters were sent in H&R Block envelopes with the “H&R Block” name marked out and the name “Community Tax Service” added to the envelopes. In that letter, June complained of H&R Block’s increased fees which she did not feel were warranted and notified the recipients that she was cancelling her H&R Block contract and would assist her “husband in his tax service in the future.” The envelopes also contained a letter written by Robert advising of his new tax preparation office using the name Community Tax Service which would operate out of the same location as the previous H&R Block office. The letter stated: “We will continue to offer the same competent service, guarantee, etc., and at the same location with the same personnel. About the only change that is being made is the name.”¹²⁷

After the H&R Block agreement was terminated, Robert also spoke with the post office advising that all mail addressed to that location should be delivered, even if it was addressed to

¹²⁵ 470 N.E.2d 756 (Ind. Ct. App. 1984).

¹²⁶ *Id.*

¹²⁷ *Id.* at 759.

H&R Block. H&R Block opened a new tax preparation office just one block away, and when the new franchisee called information to check on the H&R Block number being given, she was asked to choose from two locations, hers and Robert's. Customers intending to reach H&R Block would sometimes inadvertently call Robert's office to make an appointment. Then, when the customer would subsequently show up for the appointment, the H&R Block office would have no record of an appointment.¹²⁸

H&R Block obtained a court order enforcing June's non-compete, enjoining both Robert and June "...from participating in any business, either directly or indirectly, or by acting individually, to file, prepare, or assist in preparing income tax returns within fifty (50) miles of the City of Rochester, Indiana." The injunction was to dissolve two years after June had terminated her franchise agreement with H&R Block.¹²⁹

Robert challenged the injunction, arguing that because he did not sign June's franchise agreement containing the covenant not to compete, the court erred in enjoining him from competing with H&R Block. The trial court rejected Robert's challenge finding that because the evidence supported a finding that he acted together with June to breach her agreement with H&R Block, Robert could be enjoined from "assisting the breach" even though he did not personally sign the agreement.

The appellate court adopted the trial court's rationale for extending the injunction to both McCarts. The appellate court ultimately rejected Robert's contention that the outcome was controlled by the existence or nonexistence of a contractual relationship between Robert and H&R Block. Because the evidence demonstrated that he knowingly participated and aided June in violating the franchise agreement with H&R Block, Robert was properly included within the scope of the trial court's injunction:

If this Court were to enjoin June only and allowed Robert to continue the tax preparation trade at the same site and with the same customers the Court would be ignoring the business realities of the situation, frustrating the proper purpose of paragraph 11 of the contract, and affording June McCart indirect competition and benefit in specific violation of the contract terms. The McCarts treated the operation as their joint business (see their personal income tax returns) and held themselves out to the public that way. This Court's order will treat them in the manner they operated.¹³⁰

B. The Third-Party's Relationship with the Franchisee

McCart outlined the general circumstances under which a third-party may be bound by a covenant not to compete contained in a franchise agreement she did not sign.¹³¹ First, the party seeking to enforce the non-compete must establish that the franchisee breached the terms of the franchise agreement's covenant not to compete. Then the relationship and conduct of the

¹²⁸ *Id.*

¹²⁹ *Id.* at 758.

¹³⁰ *Id.* at 762.

¹³¹ 470 N.E.2d 756, 62.

parties is scrutinized. The precise nature of the scrutinized relationship is not limited to just familial relationships. Rather, the relationships may vary considerably and, while they can certainly consist of a familial or personal relationship, they could also involve a business connection between the franchisee and the competing business. One thing is clear—the nature of the relationship and the intricacies involved are crucial in determining if the law has been violated. However, the real test is whether the non-signatory aided or assisted the franchisee in violating his covenant against competition.

1. **Family Members**

Oftentimes, as in *McCart*, a close family relationship between the non-signatory and the franchisee may support a claim that the non-signatory aided the franchisee in avoiding the franchise agreement's non-compete provision. This section will address different familial relationships that have been analyzed by courts faced with the decision to enforce a covenant not to compete against a non-signatory in the context of a franchise agreement.

a. **Spouses**

Spouses are one of the most obvious types of familial relationships that can be used to establish a breach of a covenant not to compete against a non-signatory. Because it is such a close relationship by its very nature, scenarios involving spouses highlight the inequity of allowing one spouse, though not a signatory to the franchise agreement, to compete against the franchise in a business purportedly unaffiliated with the spouse bound by the franchise agreement and corresponding covenant not to compete. However, the relationship alone does not automatically bind the non-signatory to an agreement she did not sign. Instead, one must look at the specific facts of each relationship and the circumstances surrounding the allegedly competing business.

Dad's Properties v. Lucas, although not involving a franchise relationship, also demonstrates how courts will assess the marital relationship in considering whether to bind a non-signatory to the terms of a covenant not to compete.¹³² This case involved an “adult nightclub” featuring topless dancing, Sugar Daddy's, sold by Albert C. Lucas and Al Lucas Enterprises, Inc. to Dad's Properties. Lucas Enterprises, Inc. was jointly owned by Albert Lucas (“Albert”) and his wife, Susan E. Lucas (“Susan”). At the closing, the sellers signed a covenant not to compete agreeing not to engage in the “live adult entertainment business, either directly or indirectly, as an individual, partner, employee, stockholder or consultant” for a five year period and a fifty mile radius.¹³³ Within a year of the sale, Susan formed Martus, Inc., and began operating a topless nightclub, Fountain Blue, within the geographically restricted area. Although Susan was the sole shareholder, director and officer of the newly formed Martus, Inc., her husband Albert worked as a manager at Fountain Blue.

When Dad's Properties demanded that Albert and Susan Lucas cease operating Fountain Blue, the Lucas' argued that Susan and Martus, Inc. were not bound by the covenant not to compete because they were not a party to the sale. They further contended that the sellers, Albert Lucas and Al Lucas Enterprises, Inc., did not have any connection with establishing Fountain Blue. However, contrary to this assertion, the evidence showed that

¹³² 545 So. 2d 926 (Fla. Dist. Ct. App. 1989).

¹³³ *Id.* at 927.

Albert himself exerted considerable control over designing and operating Fountain Blue and that both Lucas' solicited Sugar Daddy's employees and dancers to work at Fountain Blue.

The *Lucas* court looked beyond the corporate fictions to find that Albert and Susan Lucas intentionally violated the covenant not to compete by setting up the competing adult nightclub. The court embraced the notion that parties may be enjoined from "aiding and abetting" a party in violating its obligations under a covenant not to compete and refused to excuse the Lucases from the covenant not to compete simply because they were, technically, not party to the agreement. The court succinctly stated its reasoning: "Mr. Lucas cannot be allowed to do indirectly, through his wife and her controlled corporation, that which he covenanted not to do himself."¹³⁴

Suburban Oil Service v. Parker also involved a husband and wife, both of whom, according to the plaintiff, were required to honor a covenant not to compete.¹³⁵ Plaintiff, Suburban Oil Service, Inc. ("Suburban Oil"), purchased a fuel oil business from C. King Parker ("Mr. Parker"). The transaction included a covenant not to compete wherein Mr. Parker agreed that "he would not, in any capacity whatsoever, engage directly or indirectly in the fuel oil business in [certain counties] for a period of seven years."¹³⁶ He also agreed not to knowingly assist anyone in acquiring customers or accounts of the oil business and subsequently became an employee of Suburban Oil, the company that bought his business. Mr. Parker's employment continued for approximately two and a half years until he unhappily resigned. Within one week, a new business known as Parker Oil Sales was formed.

Suburban Oil obtained a preliminary injunction against Mr. Parker and his wife, Harriet Parker ("Mrs. Parker"). Ms. Parker objected on the grounds that Mr. Parker's aiding and directing her participation in a new business similar to that which Mr. Parker had agreed not to compete with did not constitute a violation of the covenant not to compete. The court rejected Mrs. Parker's defense, instead reasoning that a wife should not be allowed to benefit from the proceeds of a covenant not to compete entered into by her husband and then establish a similar business in her own name. The court relied on the venerable legal doctrine, "you can't have your cake and eat it too."¹³⁷

b. Parents/Children and Elaborate Schemes

The parent/child relationship can also be the type of close relationship that is sometimes used in an effort to circumvent the restrictions of a covenant not to compete. Whether the parent is trying to help the child avoid the contractual requirements of a non-compete or the other way around, time and again courts have restricted non-parties from helping a parent or child violate the terms of the covenant not to compete.

¹³⁴ *Id.* at 929.

¹³⁵ 63 Pa. D. & C. 2d 91 (Luzerne County, Pa 1973).

¹³⁶ *Id.* at 92.

¹³⁷ *Id.* at 93.

Jackson Hewitt v. Barnes involved a father who was allegedly helping his son avoid the restrictions of a covenant not to compete contained in a franchise agreement.¹³⁸ Jackson Hewitt, Inc. (“Jackson Hewitt”), entered into eight franchise agreements with Barnes Enterprises and Richard Barnes (“Barnes”) for the operation of tax return businesses. The franchisor then sought to enforce the parties’ post-termination obligations under the franchise agreement, including removal of signage, transfer of telephone numbers, return of client files and adherence to a two-year non-compete provision of the franchise agreement. Jackson Hewitt sought to enjoin not only Barnes himself, but also “his employees, agents, independent contractors, and all those who act in concert or participation with them.”¹³⁹ Barnes argued that this language was overbroad because it impermissibly enjoined third parties who did not sign the franchise agreements.

In particular, Jackson Hewitt alleged that Barnes was attempting to avoid his post-termination obligations and that his father, Scott Barnes, planned to operate fifteen competing tax preparation businesses, using the name “Customers First”,¹⁴⁰ from the identical locations as the former Jackson Hewitt franchises. Furthermore, Jackson Hewitt alleged that Barnes was directly involved and that the former Jackson Hewitt franchise telephone numbers were impermissibly being used by Scott Barnes’ new, competing tax preparation business.

The court recognized that fact issues existed precluding summary judgment with respect to Scott Barnes’ role in the operation of the competing tax preparation business and whether his involvement in the competing business was an attempt to avoid his post-termination obligations. However, to the extent Jackson Hewitt was entitled to an injunction against Barnes, the court held it could reasonably enjoin his “affiliates, shareholders, partners, members or other parties who have a direct or indirect legal interest” from the prohibited conduct.¹⁴¹

In yet another tax preparation franchise case, this involving a mother and daughter, the court issued an injunction restricting the non-signatory daughter from competing with the tax franchise.¹⁴² *H&R Block v. Sheets* involved a tax preparation franchise operated by Letha Sheets (“Letha”) pursuant to a franchise agreement signed by Letha.¹⁴³ The franchise agreement included a non-compete, restricting Letha’s ability to compete, directly or indirectly, with H&R Block in the business of preparing tax returns for one year following termination of the franchise agreement.

¹³⁸ No. 10-cv-05108, 2011 WL 181431, *1 (D.N.J. Jan. 18, 2011).

¹³⁹ *Id.*

¹⁴⁰ The case initially referred to the competing tax preparation business as “Customers First” and later as “Citizen’s First.”

¹⁴¹ *Id.* See also *Golden Krust Patties v. Bullock*, 957 F. Supp. 2d 186 (E.D.N.Y. 2013)(Involving a non-signatory son of franchisee operating a competing business after termination of the franchise. The court enjoined both the ex-franchisee and the son. This case has an excellent discussion of the amount of bond in preliminary injunction cases).

¹⁴² 2006 U.S. Dist. LEXIS 8437 (E.D. Ky. 2006).

¹⁴³ 2006 U.S. Dist. LEXIS 8437 (E.D. Ky. 2006).

Letha and her daughter, Jennifer Sheets (“Jennifer”), were joint shareholders of Sheets Bookkeeping, Inc. (“SBI”), as well as Business Accounting Services, Inc., the entity formed to facilitate Letha’s management of the H&R Block franchise. Under the franchise agreement, Letha was required to obtain non-competes from all employees of the franchise. Although Jennifer worked with Letha in running the H&R Block franchise and was aware of this requirement, she refused to sign the employee non-compete agreement when Letha asked her to sign it.

Eventually, Letha notified H&R Block of her decision not to renew the franchise agreement upon its expiration and eventually retired. Shortly after the franchise agreement was terminated, SBI, through Jennifer, began operating a new tax preparation service from the same location as Letha’s H&R Block franchise. Jennifer and SBI sent their clients a letter advising that Jennifer and SBI had all of the clients’ personal information and they would **continue** to offer the same tax preparation services as the prior H&R Block, using the same tax preparers. The new tax preparation business operated in the same office as the prior H&R Block franchise, utilizing the same employees, furniture, computers and telephones. The court found all of this evidence supported a finding that the SBI tax preparation business was a continuation of Letha’s former H&R Block franchise. Furthermore, the court determined that Jennifer knew of her mother’s contractual obligations under the franchise agreement and actively assisted in breaching those obligations, including the non-competition provision. Consequently, the court enjoined Letha, Jennifer, SBI and related parties from competing, directly or indirectly, with the H&R Block franchise.

Sometimes, parties seeking to avoid their contractual obligations assumed under a franchise agreement are quite creative in their efforts to circumvent the covenants not to compete. *Tanfran Inc. v. Aron Alan* illustrates one of those creative schemes.¹⁴⁴ Aron Alan, LLC (“Aron Alan”) purchased four Mirage Tanning Center franchises from Tanfran, Inc. While the franchise agreement was still in existence, Aron Alan obtained a \$1 million loan from his mother’s trust, the Susan Holmes Schrottenboer Trust (the “Trust”). Tanfran terminated Aron Alan’s franchise based on a failure to pay royalties. During that same time, Aron Alan also defaulted on its payment to the Trust. To partially satisfy the outstanding debt, Aron Alan agreed to surrender its assets to the Trust. Thereafter, the Trust formed its own tanning company, Miracle Tanning, LLC (“Miracle”), and began operating a competing business using Aron Alan’s surrendered assets to provide tanning services to the same customers, in the same location, and utilizing the same employees as the prior franchise.

Tanfran sought an injunction against Aron Alan, as well as the Trust and the new tanning business, even though the latter were not parties to the franchise agreement. The Trust and Miracle contended that since they were not parties to the franchise agreement, they could not be bound by the covenant not to compete. Furthermore, they alleged that, as a secured creditor, the Trust was entitled to exercise its legal right to take possession of Aron Alan’s assets resulting from the default on the loan and that the use of those assets in a tanning business was a business decision designed to maximize the value of the surrendered collateral.

The court enjoined the Trust and Miracle from operating the competing tanning business. The evidence indicated that the timing of Aron Alan’s surrender agreement with the Trust suggested that the real motive was to avoid the effects of the Tanfran’s efforts to terminate the franchise and the covenant not to compete. Furthermore, Aron Alan’s business essentially

¹⁴⁴ No. 1:06-cv-830, 2007 WL 1796235 (W.D. Mich. June 20, 2007).

passed to Miracle without interruption, as the new business continued to use the existing telephone numbers, customer lists, operations manuals and Tanfran software. The court held that “to allow the Trust and Miracle to continue the tanning business would be tantamount to permitting Aron Alan to violate the non-competition agreements.”¹⁴⁵

Another case involving an elaborate scheme to circumvent a non-compete is *West Shores Restaurant Cop. v. Turk*.¹⁴⁶ It involved allegations that Phil Turk and Joe Lefft aided and assisted Irving Turk in avoiding the effect of a restrictive covenant. West Shores Restaurant Corporation purchased a restaurant managed by Irving Turk. In conjunction with the sale, stockholders of the seller company, including Irving Turk, executed a covenant not to compete which prevented them from, directly or indirectly, engaging in any other restaurant or similar establishment as a principal, agent, employer, employee, or in any other capacity. Irving Turk’s covenant extended for a five year period and a seven mile radius from the existing restaurant.

Several months later, Irving Turk’s father, retired businessman Phil Turk, and Irving Turk’s friend and former associate, Joe Lefft, purchased two restaurants, one of which was located in the restricted geographic area. The evidence reflected that Irving Turk was active in the negotiations for the purchase and played a dominant role therein. Furthermore, Irving Turk loaned his father, Phil, a large sum of money for the purchase. The court also found evidence that Irving Turk exerted a direct influence on the operation and management of the restaurant in the restricted area. Although the court found ample evidence that Irving Turk had himself acted in violation of the covenant not to compete, it also held that Phil Turk and Joe Lefft should be enjoined from aiding and assisting Irving Turk from breaching the covenant not to compete.

2. Current or Former Business Associates

Numerous court decisions enforcing covenants not to compete against non-signatories clearly demonstrate that a familial relationship is not required to bind a non-party. In many instances, it is a current or former business associate who is the target of a concerted effort to enforce a non-compete provision, even though he was not actually party to that agreement. While courts will certainly assess the nature of the parties’ relationship, they will also look past it and closely scrutinize the relevant conduct to determine whether the non-party’s efforts are intended to help the contractually obligated party circumvent the terms of the restrictive covenant.

In *Bonus of America v. Angel Fall Services*, Gavin Hart (“Hart”) entered into an expedited master franchise agreement with Bonus of America, a franchisor of building cleaning and maintenance services and supplies.¹⁴⁷ The expedited agreement was primarily executed so that Hart could attend the franchise’s upcoming national convention, but the parties understood that the agreement would be modified pursuant to the parties’ subsequent negotiations. Thereafter, Bonus of America, Hart, and Bonus in Minneapolis entered into two franchise agreements which granted Bonus in Minneapolis the license to use the Bonus of America marks and the right to sell Bonus of America franchises to third-parties in certain geographic areas. These franchise agreements superseded the earlier expedited agreement.

¹⁴⁵ *Id.* at *8.

¹⁴⁶ 101 So. 2d 123 (Fla. 1958).

¹⁴⁷ No. 10-2111, 2010 U.S. Dist. LEXIS 67079, *1 (D. Minn. July 6, 2010).

The franchise agreements contained, among other provisions, in-term covenants not to compete, restricting Bonus in Minneapolis' ability to assist a competitor, employ former Bonus of America employees, and participate in any business in direct competition with Bonus of America. Hart and Desiree Sanchez signed guarantees, agreeing to abide by the franchise agreement's non-compete.

Ana Diaz ("Diaz"), a third-party and stranger to the franchise agreements, incorporated Patron, a cleaning and maintenance services and supply company within the restricted territory in direct competition with the Bonus of America franchise. Patron solicited and served some of Bonus in Minneapolis' customers, and used many of the same employees and independent contractors as the Bonus of America local franchise. Bonus of America alleged and provided evidence that Hart and the franchisee played a role in Patron's daily business operations and that Patron's proposals identified Hart as the contact person, used the franchisee and Hart's certificate of liability insurance and Hart and Diaz initialed an accepted Patron customer proposal. The court held that, even though Diaz and Patron were not signatories to the franchise agreement, they should nevertheless be enjoined from competing with Bonus of America because they were in active concert and participation with Hart and Bonus of Minneapolis in competing with the Bonus of America franchise.

Apart from the lawfulness of the non-compete itself, the principal issues when a court determines whether to enforce a covenant not to compete against a non-signatory are whether the former franchisee's conduct violates the non-compete and whether the non-signatory is assisting the franchisee in those efforts to circumvent its contractual obligations. Often, however, a non-signatory will gain knowledge and information about the franchise and its operation during the term of the franchise agreement because of the non-signatory's involvement with or participation in the franchise. As demonstrated in *Little Caesar Enterprises v. Little Caesar's VA, Inc.*, even though the non-party's interest in the franchise business may not have been disclosed to the franchisor, equitable principles may support enforcing the restrictive covenant against the non-signatory.¹⁴⁸

Little Caesar Enterprises, Inc. ("Little Caesar"), the franchisor, entered into a franchise agreement with Little Caesar's VA, Inc. ("Little Caesar's VA"), the franchisee, for the operation of a pizza franchise. While still in the negotiation phase before the franchise agreement was executed, Lashunda Ross ("Ross"), who had been handling the negotiations, requested that her business associate, Steven Krever ("Krever"), be included as co-franchisee in the franchise agreement. Little Caesar rejected this request. Unbeknownst to the franchisor, Ross and Krever subsequently incorporated Little Caesar's VA, the franchisee entity, as equal co-owners and directors. Ross, as president of the franchisee company, signed a personal guarantee for the agreement and was restricted by a covenant not to compete. Little Caesar believed that Ross was the sole owner of Little Caesar's VA and did not know of Krever's involvement in the business. Therefore it did not request that Krever sign a non-compete. Although Krever did not sign the franchise agreement or execute a personal guaranty with Little Caesar, he did sign as a co-tenant on the lease for the franchise location.

Krever and Ross jointly operated the Little Caesar franchise until Krever ousted Ross from the business and the restaurant's premises, after Ross allegedly stopped paying the restaurant's bills and was instead using company funds for her personal benefit. Krever

¹⁴⁸ Bus. Franchise Guide (CCH) ¶ 14,199 (E.D. Va. 2009).

continued to operate the restaurant as a Little Caesar franchise until Little Caesar terminated the franchise agreement and sent Krever a cease and desist letter. Krever then began operating “Family Plus Pizza” after taking some measures to de-identify the restaurant as a Little Caesar franchise. However, the new Family Plus Pizza retained the same telephone number that had been used by the former franchise and the restaurant still had Little Caesar’s trade dress and utilized the franchise’s proprietary food preparation process.

Little Caesar sought an injunction against Krever based on the franchise agreement’s covenant not to compete. Krever argued that he was not a party to the franchise agreement, and thus, could not be bound by the covenant not to compete. The court rejected Krever’s defense, focusing instead on the deception used to secure the franchise agreement without notifying Little Caesar of Krever’s involvement. The court found evidence that, but for Ross and Krever’s efforts to conceal the true owners of the franchisee entity, Little Caesar would have required Krever to sign a similar guarantee and covenant not to compete. Based on principles of equity, the court refused to permit Krever to profit from “his own misdeeds, especially at the expense of Little Caesar, which appeared to have acted in this matter at all times in good faith.”¹⁴⁹

While the nature of the relationship may help establish that the non-signatory was undertaking certain efforts with the objective of aiding and assisting the party bound by the restrictive covenant, the relationship alone is not outcome determinative. *Tantopia Franchising Co v. West Cost Tans of PA* makes it clear that courts disfavor the use of strawmen to avoid one’s contractual obligations.¹⁵⁰

Tantopia involved an indoor tanning salon franchise system and a franchise agreement containing a covenant not to compete provision. The franchisee entity, West Cost Tans of PA, was owned by Donald Weiss and his son, Richard Weiss. Upon default under its lease agreement for the tanning salon, West Coast Tans ceased all operations and abandoned the personal property located in the store. Soon thereafter, the franchisee entity transferred all of its assets to a new entity, CTG Group, LLC (“CTG”) and CTG began operating a tanning business using the name “Tantopia” in the prior franchise location. The competing tanning business was allegedly owned by a third-party, who happened to be the 22 year-old son of Richard Weiss’ former fiancée who had died several years earlier. The 22 year-old had lived with both Richard and Donald Weiss for several years during his teenage years.

The court found evidence that the 22 year-old was really acting as a strawman for the franchisees to conceal their interest in the competing tanning salon. Evidence revealed that the 22 year-old’s sole paying job had been working as an hourly employee for the franchise, that the purchase price for the franchisee’s assets and business equipment had never been paid, and that the former franchisee, and not the 22 year-old, negotiated with the landlord for the new space. Furthermore, the former franchisee borrowed the money for the new business venture from a friend, although the promissory note identified the 22 year-old as the borrower. The court deduced that the 22 year-old would have been unable to enter into the new business venture without financial assistance or business advice from the former franchisees.

¹⁴⁹ *Id.*

¹⁵⁰ 918 F. Supp. 2d 407, 415 (E.D. Penn. 2013).

The court rejected the franchisee's efforts to utilize this strawman to circumvent the obligations of the covenant to compete, and entered an injunction against the franchisees and, even though not parties to the franchise agreement and the restrictive covenant, against CTG and the 22 year-old.

C. Other Considerations

To reiterate, the inquiry does not cease merely because the enforcing party proves the existence of a close relationship. While evidence of a close relationship is helpful in establishing third party liability, it is but one factor the courts consider. Courts look past the nature of the relationship and examine the circumstances surrounding the new allegedly competing business to determine whether or not to bind a non-signatory to a covenant against competition to which it was not a party. Greater overlap between the former franchisee's operations and the new competing business increases the likelihood that the enforcing party will succeed in restricting the third-party's ability to compete.

1. Same Locale/Phone Numbers Used

Evidence that the former franchisee and the new allegedly competing business share the same location and telephone numbers are very useful to a party seeking to enforce a covenant not to compete against a third party who did not sign the agreement containing the restrictive covenant. One such case is *ATC Healthcare Services, Inc. v. Southwestern Staffing Services*.¹⁵¹ ATC Healthcare Services, Inc. ("ATC") is a franchisor of businesses offering temporary personnel services for the health care community. ATC entered into a franchise agreement with Southwestern Staffing Services ("Southwestern") for the operation of an ATC franchise in Arizona. The franchise agreement, signed by Southwestern's president, William Crocker ("Crocker"), contained a one year post-term covenant not to compete and a provision that, upon termination of the franchise agreement, Southwestern would cease using the ATC telephone listing.

After a royalty payment dispute ensued between them, Southwestern notified ATC of its plans to terminate the franchise agreement and advised ATC that it had sold ATC's telephone numbers. However, when persons called the main number used by the former franchise, they discovered the line was answered "Arizona Home and Health Care". In discovery, ATC learned that Arizona Home and Health Care was being operated by Southwestern and Crocker, and that it provided health care services in direct competition with ATC.

Denying Arizona Home and Health Care's motion to dismiss, the court considered similarities between the prior franchisee and the new business. It found that ATC had made *prima facie* allegations that Southwestern and the new business venture functioned as the same entity and shared the same resources, including telephone numbers and office space.

Even in the absence of a special relationship between the franchisee and the new competing business, a covenant to compete may sometimes be enforced to restrict a franchisee from leasing to a new tenant who will be engaged in the same type of business in direct competition with the franchise. In *Victory Lane v. Darwich*, the franchisor, Victory Lane Quick

¹⁵¹ *Bus. Franchise Guide (CCH)* ¶ 12,400 (E.D.N.Y. 2001) (not for publication).

Oil Change, Inc. (“Victory Lane”) entered into a franchise agreement with Darwich Brothers LLC (“Darwich Brothers”) for the operation of a Victory Lane franchise in Saline, Michigan.¹⁵² The franchise agreement contained in-term and post-term covenants not to compete. Upon discovering that Darwich Brothers was operating two competing quick oil change centers in Lansing, Michigan, in violation of the in-term non-compete, Victory Lane terminated the franchise agreement. Darwich Brothers then sold the assets of the Victory Lane franchise to a third-party for the purpose of operating a quick oil change business. However, the landlord refused to sign the transfer of the lease on the property on which the franchise was located and Darwich Brothers remained the named tenant of the property.

The court scrutinized the post-termination covenant not to compete, which prohibited Darwich Brothers and its owners and guarantor from being connected with, having any interest in, or assisting any person or entity in competing with the franchise for two years. Because Darwich Brothers did not dispute that it had permitted a third party to occupy the same location as the former Victory Lane franchise for the purpose of conducting a similar business in direct competition with the franchise, the court found that Darwich Brothers had breached the terms of that covenant not to compete. Even though Darwich Brothers was not directly involved in the new business’ operations, as tenants of the real estate, they assisted a third-party in engaging in a competitive business in violation of the non-compete.

2. Non-Signatory’s Access to Confidential or Proprietary Information

Sometimes, a non-signatory has access to certain proprietary information or trade secrets even though that individual was not party to the franchise agreement. In those instances, if the non-signatory helps a signatory violate the terms of a covenant not to compete, the courts will enforce the non-compete provisions against the third-party. One such scenario was addressed in *Gold Messenger v. McGuay*.¹⁵³ Gold Messenger, Inc. (“Gold Messenger”) is a franchisor of advertising circulars who obtained an injunction against Jesse McGuay (“McGuay”) prohibiting him from publishing, distributing, or circulating advertising publications in competition, whether directly or indirectly, with Gold Messenger. Although Gold Messenger and McGuay had no formal, direct relationship, McGuay’s roommate and life partner had previously purchased a Gold Messenger Franchise. McGuay was present during the negotiations for the purchase of the franchise and issued a \$1,000 deposit check to secure the franchise. However, McGuay did not personally sign the franchise agreement which contained a covenant not to compete.

Following a royalty payment dispute, Gold Messenger terminated the franchise. McGuay began publishing and distributing “Penny Power”, a competing advertising circular, in the same geographic area restricted by the non-compete. Gold Messenger obtained an injunction against McGuay, preventing him from directly or indirectly competing with Gold Messenger, even though he was not a party to the franchise agreement. The court found that McGuay had access to and possession of Gold Messenger’s confidential information, namely, the franchise’s Operations and Procedures Manual, which detailed the process for setting up and operating a Gold Messenger franchise. Not only did McGuay utilize that information for the purpose of his Penny Power circulation, which the trial court noted was “quite similar” to Gold

¹⁵² No. 11-11786, 2013 WL 393020, *1 (E.D. Mich. Jan. 31, 2013).

¹⁵³ 937 P.2d 907 (Colo. Ct. App. 1997).

Messenger, but he was also paid to assist another company in starting a competing advertising circular which was modeled after the Penny Power publication.

The court rejected McGuay's argument that he could not be bound by a covenant not to compete contained in a franchise agreement to which he was not a party because in this instance, McGuay had assisted the franchisee in violating the non-compete. The court concluded that: "A non-signatory to a covenant will be bound because a covenantor will not be allowed to do through others what he or she could not do directly."¹⁵⁴ Therefore, the court will enforce a covenant against a non-signatory to the extent he assists the signatory violate the covenant not to compete.¹⁵⁵

D. Courts Refusing to Bind Non-Signatories

While the plethora of case law demonstrates that courts throughout the country are willing to enforce restrictive covenants against non-parties, such a result is not always warranted. Courts will scrutinize the facts, evaluate the two businesses and the surrounding circumstances, and then determine whether rules of equity warrant imposing a restrictive covenant on a stranger who did not sign the agreement containing the covenant not to compete.

Grease Monkey Int'l v. Ralco Lubrication Services, Inc., involved a rapid oil change business. The franchisor, Grease Monkey International, Inc. ("Grease Monkey") sought to enjoin its franchisee, Ralco Lubrication Services, Inc. ("Ralco") and its principal, Robert Lieberman ("Lieberman"), from operating a quick service oil change business at a former Grease Monkey site.¹⁵⁶ The pertinent franchise agreement contained a covenant not to compete, restricting the franchisee's ability to operate or engage in a similar business in any capacity. When Lieberman signed the franchise agreement, he made it very clear that he was only signing it in his capacity as President and owner of Ralco, and that he was unwilling to become personally liable as the franchisee. Lieberman also signed a personal guaranty in his individual capacity, personally guaranteeing Ralco's "performance pursuant to the terms of this Agreement."¹⁵⁷

Upon expiration of the franchise agreement, Ralco sold its entire inventory to Road Runner Lube and Go, LLC ("Road Runner"), an entity owned and operated by Lieberman's wife and mother-in-law. Although Lieberman did not have ownership interest in Road Runner, he was employed by Road Runner as the manager of the new oil change business operating out of the same locale as the prior franchise. Road Runner undertook a deliberate and concerted effort to de-identify the business as a Grease Monkey establishment, but it did not renovate the structure to remove a "dormer overlap roof", which was an architectural feature of and registered service mark belonging to Grease Monkey. Ralco remained in existence, but it was no longer involved in the rapid oil change business.

¹⁵⁴ *Id.* at 912.

¹⁵⁵ *Id.* Unauthorized disclosure or unauthorized use of another's trade secrets is a separate violation of statute and/or common law, as well.

¹⁵⁶ 24 F. Supp. 2d 120 (D. Mass. 1998).

¹⁵⁷ *Id.* at 122.

Under these facts, the court refused to grant the injunction against Lieberman because the evidence was insufficient to support Grease Monkey's allegations that Lieberman was personally obligated to comply with the post-term covenant not to compete. It held it was unclear whether Lieberman's signing the personal guaranty was sufficient to make him individually obligated to comply with the non-compete, and that such a finding would be required to conclude Grease Monkey had the requisite likelihood of success on its breach of contract claims against Lieberman. Thus, the court denied the injunction.

The Ninth Circuit Court of Appeals has held that a restrictive in-term covenant should not be enforced against a non-signatory absent an extraordinary relationship between the franchisee bound by the non-compete and the new competing business. In *Comedy Club v. Improv West Associates*, the court refused to bind the non-party to the restrictive covenant.¹⁵⁸ Comedy Club, Inc. and Al Copeland Investments, Inc. (collectively, "Comedy Club") entered into a license agreement with Improv West Associates ("Improv West") granting Comedy Club a license to use Improv West's trademarks. Upon Comedy Club's default under the license agreement, the agreement was not terminated, but the parties arbitrated whether the in-term covenant not to compete in the license agreement was enforceable under California law. The arbitrator found for Improv West and enjoined Comedy Club and its "Affiliates" from opening or operating any new comedy clubs or changing the name of any of their current clubs for the duration of the license agreement. The license agreement defined "Affiliates" to include "family members, family members of shareholders, all collateral relatives, former spouses, and all collateral relatives of former spouses."¹⁵⁹

The court held that the arbitrator had exceeded his authority by awarding Improv West a permanent injunction that enjoined the Affiliates.¹⁶⁰ The court reasoned that, generally, contracts do not bind non-parties in the absence of an extraordinary relationship, such as that of an intended agent, third party beneficiary, or an assignee.¹⁶¹ In this case, the license agreement's definition of Affiliates exceeded the scope of Federal Rule of Civil Procedure 65(d) (regarding injunctions) and violated California Business & Professions Code § 16600 because it was not reasonable "to preclude from gainful competition in the comedy club sphere relatives of ex-spouses of the [Comedy Club] principals who were not in an agency relationship with those principals."¹⁶² The court further reasoned that the arbitrator's injunction restricting non-party relatives and ex-spouses from engaging in a lawful business exceeded the arbitrator's authority and violated California Business & Professions Code § 16600 which codified the "general rule in California [that] covenants not to compete are void."¹⁶³ Importantly, had the covenant not to

¹⁵⁸ 553 F.3d 1277, 1281 (9th Cir. 2009).

¹⁵⁹ *Id.* at 1289.

¹⁶⁰ *Id.* at 1287.

¹⁶¹ *Id.* (citing *Benasra v. Marciano*, 92 Cal.App.4th 987, 991, 112 Cal.Rptr.2d 358 (2001); *Buckner v. Tamarin*, 98 Cal.App.4th 140, 119 Cal. Rptr. 2d 489 (2002); *NORCAL Mut. Ins. Co. v. Newton*, 84 Cal.App.4th 64, 76, 100 Cal. Rptr. 2d 683 (2000)).

¹⁶² *Id.*

¹⁶³ *Id.*

compete been post-term, the court implied it would have been unenforceable even as against the signatory, because § 16600 only upholds such covenants to protect trade secrets, or in sales of businesses or dissolutions of partnerships. The Ninth Circuit vacated the arbitrator's award to the extent it enjoined any of Comedy Club's Affiliates who were not connected to Comedy Club's principals as "officers, agents, servants, employees, and attorneys, and [upon] those persons in active concert or participation with them."¹⁶⁴ The court ruled that non-parties to an agreement can only be restrained to the extent specifically permitted by Federal Rule of Civil Procedure 65(d).¹⁶⁵

Another example of a court struggling with post-termination conduct is *Novus Franchising v. Superior Entrance Systems, et al.*¹⁶⁶ There, the Western District of Wisconsin declined to hold a franchisee in contempt of a court order, ruling that the franchisee had not violated the terms of the court's injunction, although it had come "dangerously close".

Novus Franchising, Inc. ("Novus"), an auto glass repair franchise, obtained an injunction prohibiting a former franchisee, Superior Glass, Inc. ("Superior Glass"), from violating a post-termination covenant not to compete. The terms of the covenant not to compete barred the franchise guarantor, Knute Pederson ("Pederson"), from consulting with, being connected with, having any interest in, or assisting any entity legally connected with or succeeding Superior Glass. The court order required Pederson divest himself of all interest and control in Superior Glass or ensure Superior Glass did not perform auto glass repair.¹⁶⁷ Superior Glass subsequently sold its windshield repair business to a third party, a company named "SGI Windshield Repair" ("SGI"). SGI was a newly-formed business owned by three former Superior Glass employees and was located in the same building as the former franchise. There was evidence that Superior Glass was actively referring its existing customers and all new requests to SGI.

Novus contended that Pederson violated the injunction because Superior Glass was materially assisting its successor, SGI. At the contempt hearing, the parties disagreed on whether Pedersen's actions as President of Superior Glass qualified as consulting with, being connected with, having any interest in, or assisting SGI Windshield Repair, as addressed in the non-compete. The court decided that, although Pederson was indirectly assisting SGI Windshield Repair, the indirect assistance did not violate the terms of the covenant not to compete. Although declining to find Pederson in contempt, the court was bothered by the "deliberate orchestrated transfer of the glass repair business to achieve only arguable technical compliance with the terms (if not the spirit) of the court's injunction, while at the same time preserving all of its value with the least impact on Superior Glass."¹⁶⁸ Nevertheless, efforts taken by Superior Glass to divest itself of its windshield repair business, including cancelling promotions, advertisements, and signs and forfeiting its replace/repair classification for

¹⁶⁴ *Id.* at 1288.

¹⁶⁵ *Id.* Rule 65(d) brings under its aegis the parties, their officers, agents, servants, employees, and attorneys, as well as persons in active concert or participation with the enjoined party who receive actual notice of the injunction.

¹⁶⁶ Bus. Franchise Guide (CCH) ¶ 15,082 (W.D. Wis. 2013).

¹⁶⁷ *Id.*

¹⁶⁸ *Id.*

insurance referrals, demonstrated that Superior Glass and Pederson had substantially complied with the injunction.

Finally, *Gallagher's NYC Steakhouse Franchising v. 1020 15th St. Inc.* demonstrates that an arms-length lease relationship with a non-signatory, without more, may not be sufficient to impose liability. The court held that that a former franchisee's lease of the restaurant space to a third party for the purpose of opening another restaurant was not prohibited under the terms of the covenant not to compete.¹⁶⁹ Gallagher's NYC Steakhouse Franchising, Inc. ("Gallagher's") obtained a preliminary injunction enjoining former franchisee, 1020 15th St., Inc., and its guarantor, Bruce Rahmani ("Rahmani") from "directly or indirectly engaging in any other steakhouse restaurant business."¹⁷⁰ Rahmani owned the property on which the former Gallagher's franchise had previously operated. After the court issued the preliminary injunction, Rahmani leased the space to his former chef, Guadalupe Gonzalez ("Gonzalez"), for the purpose of opening 5280 Steak House. Gallagher's moved for contempt sanctions as a result of Rahmani's alleged violation of the preliminary injunction, but the court declined to find a violation of the preliminary injunction because Rahmani's lease to Gonzalez was insufficient to show that Gonzalez was working in concert with Rahmani to violate the non-compete. Despite the franchisee leasing the former franchise location to a third party for operation of a new steakhouse, Gallagher's failed to show that there was "identity of interest or any other collusion" between the former franchisee and its guarantor, and Gonzalez.¹⁷¹

IV. CONCLUSION

Despite traditional and fundamental principles of contract law, non-signatories to an agreement can sometimes be bound by certain obligations, covenants and restrictions contained in an agreement. Thus, the analysis requires more than a superficial determination of whether the party against whom a contractual provision is sought to be enforced signed the subject agreement. Rather, notions of fairness and equity require a considerably deeper analysis with respect to the signatory and non-signatory, alike. In considering whether to enforce contractual terms against a non-signatory, courts will assess whether the non-signatory benefited, either directly or indirectly, from the agreement or whether the non-signatory aided and assisted the franchisee in avoiding the contractual obligations or restrictions imposed by the agreement. While the facts of each specific case are central with respect to any effort to enforce certain contractual provisions contained in an agreement against a non-party, non-signatories cannot rely solely on the simple proposition that one cannot be bound by an agreement she or he did not sign. Equitable principles and a wealth of case law in jurisdictions throughout the country may command otherwise.

¹⁶⁹ Bus. Franchise Guide (CCH) ¶ 14,035 (D. Colo. 2008).

¹⁷⁰ *Id.*

¹⁷¹ *Id.* at p. 5.

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