iFA INTERNATIONAL FRANCHISE ASSOCIATION

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Confidentiality, Loyalty, and Conflicts of Interest: Ethical Considerations for Counsel Representing Multiple Franchise Parties

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Who’s here today?

- In-house lawyers?
- Mediators/arbitrators?
- Lawyers in firms or solos?
- Other?
- How many of your firms represent exclusively franchisors?
- Exclusively franchisees?
- Both franchisors and franchisees?
- Both franchisors and franchisees in transactional practice only?
- Both franchisors and franchisees in litigation as well?

REPRESENTING FRANCHISORS AND FRANCHISEES AGAINST THIRD PARTIES

Hypothetical 1

Your client is a franchisor with stores nationwide. A customer enters a store operated by a franchisee. The customer injures himself in the store and files a lawsuit naming the franchisee and the franchisor as defendants.

Question 1: Are you automatically prohibited in all circumstances from representing franchisors and franchisees against third parties?

Answer: No

You are not prohibited from representing franchisors and franchisees against third parties. However, representation might be prohibited if there is a concurrent conflict of interest. ABA Model Rule 1.7 states that "a lawyer shall not represent a client if the representation involves a concurrent conflict of interest."

Comment 2 to ABA Model Rule 1.7

[2] Resolution of a conflict of interest problem under this Rule requires the lawyer to: 1) clearly identify the client or clients; 2) determine whether a conflict of interest exists; 3) decide whether the representation may be undertaken despite the existence of a conflict, i.e., whether the conflict is consentable; and 4) if so, consult with the clients affected under paragraph (a) and obtain their informed consent, confirmed in writing.

ABA Model Rule 1.7

Client-Lawyer Relationship

(a) Except as provided in paragraph (b), a lawyer shall not represent a client if the representation involves a concurrent conflict of interest. A concurrent conflict of interest exists if:

(1) the representation of one client will be directly adverse to another client; or

(2) there is a significant risk that the representation of one or more clients will be materially limited by the lawyer's responsibilities to another client, a former client or a third person or by a personal interest of the lawyer.

Question 2: Will representing the franchisee be directly adverse to your representation the franchisor?

Answer: No

There is nothing in the hypothetical to suggest that representing the franchisee will be directly adverse to your representation of the franchisor against the third party.

Question 3: Is there a significant risk that your representation of the franchisee will be materially limited by your responsibilities to the franchisor?

Answer: Likely no

The answer to this question will rely on the facts of the case and whether the facts lead to potential adversity between the franchisor and franchisee (e.g. the franchisee could have claims against the franchisor).

Comment 8 to ABA Model Rule 1.7

[8] Even where there is no direct adverseness, a conflict of interest exists if there is a significant risk that a lawyer's ability to consider, recommend or carry out an appropriate course of action for the client will be materially limited as a result of the lawyer's other responsibilities or interests. For example, a lawyer asked to represent several individuals seeking to form a joint venture is likely to be materially limited in the lawyer's ability to recommend or advocate all possible positions that each might take because of the lawyer's duty of loyalty to the others. The conflict in effect forecloses alternatives that would otherwise be available to the client. The mere possibility of subsequent harm does not itself require disclosure and consent. The critical questions are the likelihood that a difference in interests will eventuate and, if it does, whether it will materially interfere with the lawyer's independent professional judgment in considering alternatives or foreclose courses of action that reasonably should be pursued on behalf of the client.

Additional Tips

- Review franchise agreement
- Review all other agreements between franchisor and franchisee
- Review any other relevant document
- Purpose - Determining possibility of interests becoming adverse

Question 4: If you discovered a conflict of interest, does this mean you are prohibited from representing the franchisee?

Answer: Not necessarily

Parties can consent to the representation despite the existence of a conflict of interest except for those specified in ABA Model Rule 1.7.

ABA Model Rule 1.7

(b) Notwithstanding the existence of a concurrent conflict of interest under paragraph (a), a lawyer may represent a client if:

(1) the lawyer reasonably believes that the lawyer will be able to provide competent and diligent representation to each affected client;

(2) the representation is not prohibited by law;

(3) the representation does not involve the assertion of a claim by one client against another client represented by the lawyer in the same litigation or other proceeding before a tribunal; and

(4) each affected client gives informed consent, confirmed in writing.

Comment 15 to ABA Model Rule 1.7

[15] Consentability is typically determined by considering whether the interests of the clients will be adequately protected if the clients are permitted to give their informed consent to representation burdened by a conflict of interest. Thus, under paragraph (b)(1), representation is prohibited if in the circumstances the lawyer cannot reasonably conclude that the lawyer will be able to provide competent and diligent representation. See Rule 1.1 (competence) and Rule 1.3 (diligence).

Comment 18 to ABA Model Rule 1.7

[18] Informed consent requires that each affected client be aware of the relevant circumstances and of the material and reasonably foreseeable ways that the conflict could have adverse effects on the interests of that client. See Rule 1.0(e) (informed consent). The information required depends on the nature of the conflict and the nature of the risks involved. When representation of multiple clients in a single matter is undertaken, the information must include the implications of the common representation, including possible effects on loyalty, confidentiality and the attorney-client privilege and the advantages and risks involved. See Comments [30] and [31] (effect of common representation on confidentiality).

Hypothetical 2

After reviewing documents, you determine that the franchisee could potentially assert cross-claims against the franchisor.

Question 1: May you still represent the franchisee?

Answer: No

This would require advising the franchisee to assert cross-claims against your client—the franchisor. The franchisee's interests might be considered directly adverse to the franchisor's interests.

Even if the cross-claims are potential and not actual, there is a significant risk that the representation of the franchisee would be materially limited.

Additionally, ABA Model Rule 1.7(b)(3) prohibits representation when one party asserts claims against the other party.

Best practice would be to decline representation.

REPRESENTING COMPETING FRANCHISORS

Hypothetical 3

Franchisor A and Franchisor B operate in the same industry.

Your client is Franchisor A, and you are representing Franchisor A in a breach of contract litigation.

Franchisor B is attempting to open a store close in proximity to a store operated by Franchisor A.

However, Franchisor B has not been able to open its store because of a recent lawsuit alleging violations of zoning laws. Franchisor B asks you to represent it in the lawsuit.

Question 1: May you represent Franchisor B in its lawsuit?

Answer: It depends

ABA Model Rule 1.7

Client-Lawyer Relationship

(a) Except as provided in paragraph (b), a lawyer shall not represent a client if the representation involves a concurrent conflict of interest. A concurrent conflict of interest exists if:

(1) the representation of one client will be directly adverse to another client; or

(2) there is a significant risk that the representation of one or more clients will be materially limited by the lawyer's responsibilities to another client, a former client or a third person or by a personal interest of the lawyer.

Question 2: Are the interests of Franchisor B directly adverse to Franchisor A?

Answer: No

Parties that are solely economically adverse are not directly adverse to each other under ABA Model Rule 1.7(a).

"Direct adverseness requires a conflict as to the legal rights and duties of the clients, not merely conflicting economic interests."

-ABA Formal Opinion 05-434 (Dec. 8, 2004)

Comment 6 to ABA Model Rule 1.7

[6] Loyalty to a current client prohibits undertaking representation directly adverse to that client without that client's informed consent. Thus, absent consent, a lawyer may not act as an advocate in one matter against a person the lawyer represents in some other matter, even when the matters are wholly unrelated. The client as to whom the representation is directly adverse is likely to feel betrayed, and the resulting damage to the client-lawyer relationship is likely to impair the lawyer's ability to represent the client effectively. In addition, the client on whose behalf the adverse representation is undertaken reasonably may fear that the lawyer will pursue that client's case less effectively out of deference to the other client, i.e., that the representation may be materially limited by the lawyer's interest in retaining the current client. Similarly, a directly adverse conflict may arise when a lawyer is required to cross-examine a client who appears as a witness in a lawsuit involving another client, as when the testimony will be damaging to the client who is represented in the lawsuit. On the other hand, simultaneous representation in unrelated matters of clients whose interests are only economically adverse, such as representation of competing economic enterprises in unrelated litigation, does not ordinarily constitute a conflict of interest and thus may not require consent of the respective clients.

Question 3: May you represent Franchisor B in its lawsuit?

Answer: Yes, if representation satisfies ABA Model Rule 1.7(a)(2) and (b)

The litigations involving Franchisor A and Franchisor B are unrelated, meaning they are just economic competitors. Thus, Franchisor B is not directly adverse to Franchisor A. However, you must still determine whether there is a significant risk your representation of Franchisor B will be materially limited, and if so, whether the conflict is consentable.

Question 4: Do you need to disclose representation of a competitor to a client?

Answer: No

The ABA has noted that "courts have consistently upheld the general principle that business interests or economic adversity do not create ethical conflicts of interest under the Model Rules."

-ABA Center for Professional Responsibility, *Corporate Counsel Policies—Who do You and Who Can You Represent?*, 24 The Professional Lawyer n.2 (June 15, 2016).

Curtis v. Radio Representatives, Inc. (D.D.C.)

- Prior to retaining the law firm, the client asked the law firm whether the firm represented any of the client's competitors.
- The law firm never disclosed that it represented several competitors.
- The client argued the law firm violated ethical rules.
- Court held that "standing alone, defendant's bare allegation that it considers these stations to be competitors is not sufficient to establish a violation of [ethical rules]."

POSITIONAL CONFLICTS WHEN REPRESENTING FRANCHISORS AND FRANCHISEES

Hypothetical 4

Longstanding Client 1: Taco the Town, Inc., franchisor with over 500 U.S. locations. Your firm regularly enforces post-termination non-competes for Taco the Town.

Taco the Town sues a former franchisee in federal court in State A, for breach of a noncompete.

You argue that franchise noncompete provisions are presumptively enforceable because franchisees are not "employees" and therefore are not subject to heightened scrutiny under state noncompete law for employees.

This is an open issue in State A. You urge the court to adopt a bright line distinction between franchisees and employees.

Potential Client 2: franchisee Smoothie Operator, LLC, a franchisee of a smoothie franchise asks you to represent it in federal court in State B.

Smoothie Operator wants to sue its franchisor for declaratory relief that its post-termination noncompete is unenforceable.

If hired, you would argue that the noncompete is unenforceable because franchisees are economically dependent, lack bargaining power, and should be treated like employees or quasi-employees for purposes of restrictive covenant analysis.

This is an open issue under the law of State B.

Question 1: Are you automatically prohibited in all circumstances from taking opposite legal positions in different cases?

Answer: No.

Positional conflicts are not per se prohibited in all circumstances. Under Model Rule 1.7, the mere fact that advocating a legal position on behalf of one client might create precedent adverse to the interests of a client represented by the lawyer in an unrelated matter does not automatically create a conflict of interest

Comment 24 to ABA Model Rule 1.7

[24] Ordinarily a lawyer may take inconsistent legal positions in different tribunals at different times on behalf of different clients. The mere fact that advocating a legal position on behalf of one client might create precedent adverse to the interests of a client represented by the lawyer in an unrelated matter does not create a conflict of interest. A conflict of interest exists, however, if there is a significant risk that a lawyer's action on behalf of one client will materially limit the lawyer's effectiveness in representing another client in a different case; for example, when a decision favoring one client will create a precedent likely to seriously weaken the position taken on behalf of the other client. Factors relevant in determining whether the clients need to be advised of the risk include: where the cases are pending, whether the issue is substantive or procedural, the temporal relationship between the matters, the significance of the issue to the immediate and long-term interests of the clients involved and the clients' reasonable expectations in retaining the lawyer. If there is significant risk of material limitation, then absent informed consent of the affected clients, the lawyer must refuse one of the representations or withdraw from one or both matters.

Factors to Determine Material Limitation

- Is the issue of such importance that its determination is likely to affect the ultimate outcome of at least one of the cases?
- Is the determination of the issue in one case likely to have a significant impact on the determination of that issue in the other case?
- Will there be any inclination by the lawyer or the law firm to "soft-pedal" or de-emphasize certain arguments or issues—which otherwise would be vigorously pursued—so as to avoid impacting the other case?
- Will there be any inclination within the firm to alter any arguments for one, or both clients, so that the firm's position in the two cases can be reconciled—and, if so, could that redound to the detriment of one of the clients?

-ABA Formal Opinion 93-377 (Oct. 16, 1993)

Factors to Determine Informing Clients

- Where the cases are pending
- Whether the issue is substantive or procedural
- The temporal relationship between the matters
- The significance of the issue to the immediate and long-term interests of the clients involved
- The clients' expectations in retaining the lawyer

-Comment 24 to ABA Model Rule 1.7

Question 2: Is there a conflict of interest even though the clients are in different franchise systems and are not adverse to each other?

Answer:

Probably yes—this looks like a classic positional conflict.

ABA Model Rule 1.7:

- A concurrent conflict of interest exists if…there is a significant risk that the representation of one or more clients will be materially limited by the lawyer's responsibilities to another client, a former client or a third person or by a personal interest of the lawyer.

Per ABA Model Rule 1.7 and Comment 24 to Model Rule 1.7, the key question is whether there is a significant risk that your action on behalf of Smoothie Operator will materially limit your effectiveness in representing Taco the Town in your ongoing representation of Taco the Town.

Why likely a conflict?

- The two cases are in different jurisdictions and involve unrelated franchise systems with different noncompete clauses, but a similar legal issue.

- Arguing that franchisees are “independent business owners” in one case and “functionally employees” in another could risk undermining Taco the Town’s systemic enforcement efforts and damaging both clients’ confidence and trust.

- When noncompete legal issues are open in one state, lawyers often cite to analogous decisions in other states. The lawyer for the Smoothie Operator’s franchisor could easily locate the briefing you do for Taco the Town, and any victories you obtain for Taco the Town, and use them against Smoothie Operator.

- If you are engaged to systematically enforce Taco the Town non-competes across the country (including possibly in State B in the future), Taco the Town may reasonably expect that you will not create harmful precedent for it in State B or other states.

Arguments Against Conflict

If there are

- meaningful differences in the existing state law of State A and State B (the content of state noncompete statutes, existing analogous precedent, etc.), or
- meaningful factual distinctions between Smoothie Operator and Taco the Town franchisees and their noncompete clauses,

you may be able to effectively make different arguments on behalf of each client simultaneously in States A and B based on state statutory language and case-specific facts rather than broad legal theories.

If Taco the Town only franchises in a handful of states (not including State B), and has no plans to expand beyond these states, and you can draw meaningful distinctions between States A and B, you may be more free to advocate on behalf of Smoothie Operator in State B without it impacting Taco the Town (or your representation of Taco the Town).

Question 3: May you proceed with both representations?

Answer: Possibly.

If you reasonably believe that you can "provide competent and diligent representation to" both Smoothie Operator and Taco the Town, then under Model Rule 1.7(b) you can proceed if both Smoothie Operator and Taco the Town give informed consent, confirmed in writing.

Question 4: What is “informed consent”?

Answer:

Per Model Rule 1.0(e) "Informed consent" denotes the agreement by a person to a proposed course of conduct after the lawyer has communicated adequate information and explanation about the material risks of and reasonably available alternatives to the proposed course of conduct.

Question 5: Is written disclosure required even if you believe no real harm will occur?

Answer: Probably yes.

At minimum, there is probably a "significant risk" that representation of Smoothie Operator will be materially limited by the lawyer's responsibilities to Taco the Town, so written disclosure is likely required under Model Rule 1.7.

Written disclosure is likely also required under Model Rule 1.4(a)(1): "A lawyer shall (1) promptly inform the client of any decision or circumstance with respect to which the client's informed consent" is required by these Rules."

Question 6: What is your safest course of action?

Answer:

Safest options include:

1. With respect to the Smoothie Operator/ Taco the Town conflict, decline the Smoothie Operator matter as that was the second potential representation

2. More broadly, for litigation that involves recurring franchise issues, choose to represent franchisors or franchisees. This does not mean you must always represent franchisors or franchisees for all legal work.

- Doing transactional work for both franchisors and franchisees may be less problematic
- Doing litigation that does not involve recurring franchisor-franchisees issues (for example, many vendor breach-of-contract claims) may be less problematic

3. Draft the scope of engagement narrowly in engagement letters – for example, we will handle the franchisee-landlord dispute only (and will not advise on other issue, like issues between the franchisee and its franchisor).

BUSINESS CONFLICTS IN REPRESENTING FRANCHISORS AND FRANCHISEES

Hypothetical 5

You represent several franchisors in their FDD work and represent potential franchisees (of other systems that are not owned by your franchisor clients or their affiliates) in evaluating FDDs.

Question 1: Is this a conflict for purposes of Model Rule 1.7?

Answer: Probably not.

There is likely not a significant risk that your simultaneous representation of franchisors and franchisees with respect to FDD preparation (franchisors) and FDD review (franchisees) will materially limit your responsibilities to such clients (the test under Model Rule 1.7).

Question 2: If it is not a legal conflict, what business conflicts do I need to consider?

Answer: Client perceptions of loyalty and increased risk of future conflicts.

Client Perceptions of loyalty:

Franchisor or franchisee clients often assume their counsel is “on a side.”

If you represent some franchisors, franchisee clients may worry you are less on their side and advocate less aggressively for them (and vice versa for franchisor clients). Franchisees in particular may worry that you are more aligned with franchisor clients, who tend to be repeat players (annual FDD) vs. one-off.

Clients may be concerned that your representation of “the other side” will cause indirect harm to “their side”.

Example:

- On the franchisor-side, lawyers typically argue against caps on franchisees’ personal guaranties; on the franchisee-side, lawyers often argue for caps on franchisees’ personal guaranties.

- If you (on behalf of franchisees) persuade several franchisors to agree to such caps, your franchisor clients may think you are not helping franchisors industry-wide in their negotiating position.
- (Of course, you may be facilitating deals that would not otherwise happen at all without such concessions, in which case at least arguably everyone wins.)

Is this valid?

Increased risk of future conflicts:

Consider the speed with which parties become adverse unexpectedly.

Examples:

- a franchisee you represent in an FDD review later has a franchise agreement dispute with their franchisor;
- a franchisor client acquires a brand where you already represent franchisees;
- and non-adverse matters spawn indemnity issues.

This can result in disqualification motions, forced withdrawals, disrupted strategy, and client frustration.

REPRESENTING FRANCHISORS IN INSURANCE-FUNDED LITIGATION

Hypothetical 6

Plaintiff Dough & Behold, LLC sues bakery café franchisor Scone but Not Forgotten, Inc. (“SBNF”), alleging SBNF made negligent and misleading representations during the franchise sales process and in the FDD, inducing them to sign a franchise agreement and invest $$.

SBNF tenders the suit to its insurance carrier, and the carrier accepts defense (without issuing a reservation of rights letter).

The carrier appoints panel counsel (you).

The carrier imposes litigation guidelines, including: pre-approval for discovery, experts, mediation, and settlement authority; detailed early case assessments; and upload of all significant documents, including sales materials and internal emails.

Question 1: Who is your client in this insurer-funded defense?

Answer:

The insured (SBNF) is definitely your client.

The trickier question is whether the insurer is also your client. Whether the insurer is also your client varies by state law.

The Model Rules of Professional Conduct do not answer whether a lawyer retained and paid by an insurer to defend its insured represents the insured, the insurer, or both, leaving room for a jurisdictional split.

Many jurisdictions hold that defense counsel represents both the insured and the insurer, at least where there is no conflict.

Other jurisdictions hold that the insured is the sole client of defense counsel appointed by the insurance carrier.

Question 2: Can you allow the insurer to interfere with your professional judgment with respect to defending SBNF?

Answer: No.

Model Rule 1.8(f) provides: A lawyer shall not accept compensation for representing a client from one other than the client unless:
(1) the client gives informed consent;
(2) there is no interference with the lawyer's independence of professional judgment or with the client-lawyer relationship; and
(3) information relating to representation of a client is protected as required by Rule 1.6.

Model Rule 5.4(c) provides: “A lawyer shall not permit a person who recommends, employs, or pays the lawyer to render legal services for another to direct or regulate the lawyer's professional judgment in rendering such legal services.”

State ethics committees have also addressed this issue.

The Utah State Bar Ethics Advisory Opinion Committee has opined:

“An insurance defense lawyer must not permit compliance with guidelines and other directives of an insurer relating to the lawyer's services to impair materially the lawyer's independent professional judgment in representing an insured. If compliance with the guidelines will be inconsistent with the lawyer's professional obligations, and if the insurer is unwilling to modify the guidelines, the lawyer must not undertake the representation.”

Question 3: If you uncover information that you reasonably believe will hurt coverage, can you share that information with the carrier without the insured's informed written consent? Is that still true if the carrier's guidelines require you to disclose such information?

Answer: No.

You cannot share such information without the insured's informed consent, even if the carrier's guidelines require you to disclose such information.

If you reasonably believe that disclosure of the insured's confidential information to the insurer will affect a material interest of the insured adversely, you must not disclose such information without the informed consent of the insured.

ABA Formal Opinion 01-421 (Ethical Obligations of a Lawyer Working Under Insurance Company Guidelines and Other Restrictions) (February 16, 2001)

Buchanan v. Leonard, 428 N.J. Super. 277, 52 A.3d 1064 (App. Div. 2012), provides a cautionary tale.

- A lawyer (Leonard) was defense counsel (paid for by insurer) for another lawyer (Buchanan) in a malpractice action against Buchanan.

- Leonard revealed in a report to the insurer that the insured lawyer (Buchanan) had engaged in fraud.

- After reading the report, the carrier rejected the request to authorize the settlement, and instead withdrew its defense and declined all coverage under the policy, citing the policy's "fraud exclusion."

- The insured (Buchanan) sued Leonard for malpractice for sending the report to the insurer. The insured argued that Leonard had breached his duty to represent him with undivided loyalty. Buchanan contended that Leonard's statements virtually assured that the insurer would withdraw coverage.

- Leonard argued that he was merely providing the insurer with his candid assessment of Buchanan's potential liability in the lawsuit.

- The appellate court held that the trial court should have allowed Buchanan to provide expert testimony on the standard of care that Leonard should have employed, and remanded for further proceedings.

Question 4: If coverage issues arise, what should you do?

Answer:

Generally, in most jurisdictions, you should recommend that the insured obtain independent coverage counsel and not advise on coverage issues yourself.

See, e.g., Board of Professional Responsibility of the Supreme Court of Tennessee, 1985 WL 1157806, at *3 (“the attorney is ethically prohibited from representing or advising either the insured or insurer when a conflict arises between the insured and insurer over the coverage or terms of the policy of insurance. In such instances the attorney should advise either or both parties to seek independent legal advice and representation regarding the matter.”)

Question 5: The insurer wants to settle a case and the client (franchisor SBNF) refuses to settle. What are your options if the insurance policy authorizes the insurer to control the defense and to settle within policy limits within insurer’s sole discretion?

Answer:

If the insurer wants to settle a case and the insured SBNF refuses to settle, then you may not settle the case.

Model Rule of Professional Conduct Rule 1.2 provides, “A lawyer shall abide by a client's decision whether to settle a matter.

Model Rule 1.2 requires you to abide by the insured-client SBNF’s decision regarding settlement, even if the insurance company has a contractual right to control settlement.

ABA Formal Ethics Opinion 96-403: “So long as the insured is a client, however, the Rules of Professional Conduct--and not the insurance contract--govern the lawyer's obligations to the insured.”

ABA Formal Ethics Opinion 96-403 advises,

"If after accepting the limited representation offered under the insurance contract, the insured and the insurer disagree as to whether a proposed settlement is acceptable and, moreover, who has the right to decide that question under the insurance contract, the lawyer may consult with his client or clients as to the likely consequences of a proposed course of conduct or <u>advise the parties to seek independent counsel</u>, and indeed in some circumstances he may be required to do so. Rule 1.7(a).

Thus, for example, the lawyer might remind the insured that the policy gives the insurer the right to control the defense and settle the claim without the consent of the insured or that rejecting the proposed settlement might result in a forfeiture of his rights under the policy.

Ultimately, however, although the insurer hires the lawyer and pays his fee, the insured retains the power to reject the defense offered by the insurer under the policy and to assume the risk and expense of his own defense."

Questions?

Thank you!