Franchisor not intended beneficiary for mandatory mediation in franchisee equity dispute

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The Reale Group, comprised of Global Pacific, LLC and Christopher Reale (the sole owner and member of Global Pacific), and the Kirkpatrick Group executed and delivered an operating agreement for R&K Machinery, LLC, in 2006. R&K was formed to operate a franchise of BlueLine Rental, LLC. BlueLine is a rental construction equipment company with franchisees located throughout the United States. Christopher Reale also operated three other BlueLine franchisees through various separate companies from R&K.

R&K's 2006 operating agreement stated that the Reale Group and the Kirkpatrick Group agreed to mediate any disputes that arose between them, and to arbitrate if mediation proved unsuccessful.

In 2008, Christopher Reale's BlueLine franchised locations (other than R&K) suffered economic hardship and began defaulting on obligations owed to creditors, including BlueLine. In 2010, Reale entered into an agreement with BlueLine wherein BlueLine wrote off certain debts owed by Reale in exchange for Reale surrendering his membership interests in R&K and his other three BlueLine franchised locations. The terms of the 2010 agreement required the Reale Group to transfer all of its interests in R&K to the Kirkpatrick Group and BlueLine agreed to prepare the assignments of the membership interest.

In 2015, the Reale Group sued the Kirkpatrick Group in the Butler County Court of Common Pleas alleging

that its interests in R&K were never actually transferred to the Kirkpatrick Group and asserting claims for profits, distributions and other damages. The Kirkpatrick Group moved the trial court to stay the proceedings and compel arbitration under the 2006 R&K operating agreement. In addition, the Kirkpatrick Group filed a third-party complaint against BlueLine for indemnification. The trial court ordered the parties, including BlueLine, to mediate and/or arbitrate the matter per the terms of the 2006 R&K operating agreement. BlueLine appealed the trial court's order arguing that it was not a party to the 2006 R&K operating agreement and, therefore, the mediation and arbitration provisions contained therein were not binding on BlueLine.

Ohio Supreme Court ruling on a party arbitrating a dispute between itself and a second party

In Ohio, the Ohio Supreme Court has ruled that a party to an action generally cannot be required to arbitrate a dispute between itself and a second party unless the parties have previously agreed in writing to arbitrate those disputes. This legal principle is based on the fact that arbitrators derive their authority to resolve disputes only because the parties have agreed to submit such grievances to arbitration. (See, *Council of Smaller Enters. v. Gates, McDonald & Co., 80 Ohio St.3d 661, 666 (1998)*) Notwithstanding the foregoing, the Ohio Supreme Court has also held pursuant to the equitable estoppel doctrine that non-signatories can be bound by an arbitration clause if the non-party was an intended beneficiary using "the intent to benefit test." (*Hill v. Sonitrol of Sw. Ohio, Inc., 36 Ohio St.3d 36 (1988)*)

Intent to benefit test for determining beneficiary

Under the "intent to benefit test," a beneficiary is an intended beneficiary if recognition of a right to performance in the beneficiary is appropriate to effectuate the intention of the parties…and the circumstances indicate that the promise intends to give the beneficiary the benefit of the promised performance. In order for a third party to be an intended beneficiary under a contract, that intent must be clear from the language of the contract itself. If the promisee has no intent to benefit a third party, then any third-party beneficiary to the contract is merely an "incidental beneficiary," who has no enforceable rights under the contract. The mere conferring of some benefit on the alleged beneficiary by the performance of a particular promise in a contract is insufficient to meet the "intent to benefit test."

The Court of Appeals for the Twelfth Appellate District of Ohio ruled on April 10, 2017 that

1. BlueLine was not a party to the 2006 R&K operating agreement.
2. The existence and operation of an active franchisee of BlueLine that paid BlueLine as franchisor was not sufficient to make BlueLine an intended beneficiary.
3. BlueLine did not try to enforce any rights created by the 2006 R&K operating agreement.
4. Judicial economy does not trump the fact that BlueLine is not an intended beneficiary.

Takeaway

Parties to a written contract compelling arbitration and/or mediation should require any alleged third-party beneficiary to sign a written agreement to arbitrate disputes arising among them. Without the written agreement, you risk a court ruling that the alleged third-party beneficiary is merely an incidental beneficiary of the contract and not subject to the mandatory arbitration and/or mediation provisions contained therein.

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