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LITIGATION ALERT

PUERTO RICO SUPREME COURT ISSUES DECISIONS FAVORING COMMERCIAL ARBITRATION AND ADOPTING A REASONABLENESS STANDARD FOR NONCOMPETITION CLAUSES IN FRANCHISE CONTRACTS

The Puerto Rico Supreme Court recently issued separate decisions in which it bolsters the public policy favoring arbitration clauses in commercial contracts, Méndez Acevedo v. Nieves Rivera 2010 TSPR 105, and adopts a reasonableness standard for the analysis of noncompetition clauses in franchise contracts, Franquicias Martin's BBQ, Inc. v. Luis Garcia de Gracia, 2010 TSPR 71.

In Méndez Acevedo v. Nieves Rivera, the Court held that an arbitration clause is binding even when a party to the contract containing the arbitration clause alleges the contract is null and void. It explained that the determination of the validity of the contract - rather than the validity of the arbitration clause itself- must be resolved by the arbitrator and not the courts.

Méndez Acevedo v. Nieves Rivera arose out of a dispute between two partners who had entered into an agreement for the purchase and sale of motor vehicles. The partnership contract contained a broad arbitration clause which referred all disputes and controversies arising from or relating to the agreement to binding arbitration. One of the partners challenged the validity of the arbitration agreement because the contract had not been executed in a public instrument before a notary public.

The Supreme Court determined that challenges to the validity of an entire contract - in contrast to challenges aimed at the arbitration clause contained within it - are within the arbitrator's authority. It further explained that an arbitration provision is severable from the rest of the contract. Thus the issue of the contract's validity should be considered by the arbitrator in the first instance if the arbitration clause is broad enough to allow the arbitrator to do so. With this decision, the Supreme Court has further made clear its

intention to strengthen the public policy in Puerto Rico favoring arbitration by eliminating obstacles to the enforcement of an arbitration provision.

In Franquicias Martin's BBQ, Inc. v. Luis Garcia de Gracia, the Supreme Court of Puerto Rico issued an important ruling which will have an impact on how noncompetition clauses are drafted and interpreted under Puerto Rico law.

The dispute arose in the context of a franchise agreement. The franchisee, Garcia, operated a rotisserie chicken restaurant pursuant to a franchise agreement with Martin's BBQ, Inc. The franchise contract included a noncompetition clause that prohibited the franchisee from competing within a 10-mile radius of any of the franchise's restaurants for a two-year period after the contract's expiration. Under the franchise contract, the franchised area of operation was only a two-mile radius.

While the Court found that the two-year limitation was reasonable, it concluded that the geographic limitation was not. Specifically, given that the contract itself provided that the franchisee's area of operation was limited to a two-mile radius, the Court held the 10-mile limitation in the noncompetition clause was excessive and, therefore, null and void. In reaching its holding, the Court concluded that, in this case, the area restricted from competition after the termination of the franchise should be limited to an area no greater than the area of operation during the effective period of the contract.

In addition, the Court emphasized that it was refusing to establish specific time, geographic, and material parameters on all noncompetition clauses in franchise agreements due to the fact that the reasonableness of these restrictions could vary on a case by case basis. The Court also stated that the overarching factors in determining the reasonableness of these clauses is whether they protect the franchisor's legitimate interest, and whether they cause any undue hardship on the franchisee or the public interest. Due to the fact that the Court views these noncompetition clauses on a case by case basis, businesses should review their noncompetition clauses carefully in order to ensure their reasonableness. Businesses should also take into account the Court's analysis in negotiating and drafting each clause in the future.

Should you have any questions or comments, or wish additional information regarding this matter, please contact Francisco G. Bruno, Chair of our Litigation Practice Group at (787) 250-5608 or via email fgb@mcvpr.com. The contact information of our Litigation Practice Group attorneys is available on our website