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Expect the Unexpected: The Need for Control to Impose Vicarious Liability in Strategic Alliances

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EXPECT THE UNEXPECTED: THE NEED FOR CONTROL TO IMPOSE VICARIOUS LIABILITY IN STRATEGIC ALLIANCES

The recent proliferation of strategic alliances[1] has increased the importance of determining the legal relationship of member firms. One area that must be addressed is the vicarious liability of a firm when another member of the alliance is held liable in tort or contract. Holding firms in a strategic alliance vicariously liable for the acts of an ally may not be a cost the firm bargained for or was able to foresee. Thus, measures to allocate risk and minimize costs may not have been taken. When firms do not allocate risk properly beforehand, it is unfair to hold them vicariously liable unless they had the right to control the actions that gave rise to the liability. The variance with which vicarious liability is imposed in different types of strategic alliances and in different jurisdictions makes it difficult to predict when vicarious liability will be imposed. A test that can be applied consistently is therefore necessary so that firms can minimize liability efficiently, and not incur transaction costs in ascertaining potential liability on a jurisdiction-by-jurisdiction basis. This Comment argues that the appropriate test is whether a firm has the right to control the specific conduct or performance of the ally which gave rise to the liability.

In exploring the adequacy and need for this test, Part I of this Comment focuses on the legal relationship of firms in a strategic alliance, and how vicarious liability fits within that framework. Part II examines the extent to which a firm should be vicariously liable for the torts and unauthorized contracts of an ally and argues

[1] George W. Dent, Jr., *Gap Fillers and Fiduciary Duties in Strategic Alliances*, 57 BUS. LAW. 55, 55 (2001) (noting that the importance and proliferation of strategic alliances are a result of economic and technological changes); *see also* Stephen Fraidin & Radu Lelutiu, *Strategic Alliances and Corporate Control*, 53 CASE W. RES. L. REV. 865, 865 n.3 (2003) (citing Jeff Coburn, *All for One: Strategic Alliances Between Firms Are Good for Clients, Business*, LEGAL MGMT., Sept.-Oct. 1998, at 46-47 ("[I]f the 1980s was the 'Decade of the Merger/Acquisition' then the 1990s is becoming the 'Decade of the Strategic Alliance.'")).

that only where the firm has the right to control the conduct in question should vicarious liability be imposed. Finally, Part III illustrates the role that control plays in determining the vicarious liability of firms in strategic alliances by focusing on joint ventures and franchises, and demonstrates that the inconsistent tests among jurisdictions make gauging potential liability difficult and hinder efforts to minimize liability.

I. THE STRATEGIC ALLIANCE FRAMEWORK

To understand the role of vicarious liability in strategic alliances, it is first necessary to understand the legal relationship of firms in strategic alliances. It is then prudent to examine how vicarious liability fits within the structure of strategic alliances.

A. What Is the Legal Relationship of Firms in a Strategic Alliance?

Strategic alliances include legal relationships such as joint ventures, franchises, dealerships, distributorships, licensing arrangements, and strategic investments.[2] Often, a strategic alliance pertains to a project and not an overall business undertaking.[3] There are, however, many different motivations to enter into a strategic alliance, which vary by industry, by company, and by alliance.[4] Regardless of the motivations for entering into a strategic alliance, the legal relationship depends on form.

Firms must make many important decisions in choosing the form of the alliance. One important issue in structuring an alliance is whether to create a separate entity.[5] For instance, one type of strategic alliance, the joint venture, is normally treated as a general partnership.[6] Frequently, however, a corporation is created for the joint venture to operate under,[7] in which case the parties to the al-

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[2] Dent, *supra* note 1, at 55; *see also* Fraidin & Lelutiu, *supra* note 1, at 868 (stating that strategic alliances in the 1990s can be categorized into seven categories: "technology distribution ventures; cross-licensing arrangements and joint product development ventures; industry coordination ventures; research consortia; start-up ventures; access to foreign markets arrangements; and, 'no paradigm' ventures").

[3] Phillip I. Blumberg, *Control and the Partly Owned Corporation: A Preliminary Inquiry into Shared Control*, 10 FLA. J. INT'L L. 419, 462 (1996). It should be noted that Blumberg does, however, distinguish strategic alliances from joint ventures.

[4] Ruthanne Kurtyka, *Strategic Alliances: What, Why and How?*, *in* STRUCTURING, NEGOTIATING & IMPLEMENTING STRATEGIC ALLIANCES 41, 43 (PLI/Corp. 2000) (setting forth the motivations to enter strategic alliances).

[5] George Dent, *Lawyers and Trust in Business Alliances*, 58 BUS. LAW. 45, 67 (2002) (noting that the choice of entity depends upon legal issues such as taxes and limited liability, as well as transaction-cost economics).

[6] *Id.* (noting also that the joint venture implies "a single, limited enterprise rather than a broad collaboration of indefinite duration").

[7] *Id.*

liance are treated as shareholders of the corporation and not as general partners. The legal relationship in other strategic alliances is often unclear.[8] It has been observed that "[i]n a franchise, dealership, distributorship, or licensing agreement, each party pursues profit, but these arrangements are usually not partnerships because profits are earned separately, not shared from a single pool."[9] Where the line is unclear, the relationship of the parties ought to be governed by contract and the default rules appropriate to the specific type of contract.[10] However, even that approach to determining the legal relationship may be difficult to apply because the default rules associated with the specific type of contract can vary from jurisdiction to jurisdiction.

The level of fiduciary duties of firms in strategic alliances is influenced by the choice of entity.[11] The fiduciary duties owed in a partnership are high, while the fiduciary duties owed in other forms, such as corporations, are more uncertain.[12] When a separate corporation is the entity under which the strategic alliance operates, the allies owe each other and the common alliance fiduciary duties of care and loyalty.[13] The duty of loyalty in such a relationship is more problematic because "investors in many alliances are actual or potential competitors of the enterprise in which they invest and . . . such investors often participate in different alliances that may be competitive with each other."[14] Fiduciary duties are important in an alliance because they may determine "whether one party to an alliance must share a business opportunity with the other or can dissolve the alliance and force a sale of its assets."[15] A breach of a fiduciary duty by one firm can give rise to a claim against it by its ally. Firms in strategic alliances may modify fiduciary duties to some extent, but this often imposes additional costs in forming the alliance.[16]

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[8] *Id.*

[9] *Id.* (noting that under UNIF. P'SHIP ACT § 7 (1914), the receipt of a share of the profits of a business is prima facie evidence that the person is a partner in the business).

[10] *See* Larry E. Ribstein, *Limited Liability Unlimited*, 24 DEL. J. CORP. L. 407, 410 (1999) (arguing that a business firm does not have to fit within one of the accepted business association categories in order to limit the owners' liability for the firm's debts).

[11] Dent, *supra* note 5, at 68.

[12] *Id.* (stating that fiduciary duties in non-public corporations are uncertain).

[13] Fraidin & Lelutiu, *supra* note 1, at 874.

[14] *Id.* at 875.

[15] Dent, *supra* note 5, at 68.

[16] *Id.*

B. Vicarious Liability in the Strategic Alliance Framework

Vicarious liability may be imposed on a firm for the conduct of its ally. Vicarious liability is "the imposition of liability upon one party for a wrong committed by another party."[17] Imposition of vicarious liability depends in part upon the nature of the activity in which the wrong arises.[18] Business principals are often held vicariously liable for the wrongs of their agents even if they do not order, authorize, or encourage the agent to commit the wrong.[19] Vicarious liability generally extends to torts and unauthorized contracts by the principal's agent.[20] It is in these circumstances that firms in strategic alliances may come to be liable for their allies' debts.

It is without question that owners of firms are vicariously liable for the firm's debts.[21] One deviation from this principle, however, is that the shareholders of a corporation are its owners but are not vicariously liable for its debts. An owner is one who both controls and receives profits from the use of that control.[22] "A sole controller and residual claimant is a principal in an agency relationship, while one who shares ownership rights is a partner."[23] If the relationship of the firms in the alliance results in co-ownership, then the firms may be vicariously liable for one another's debts.[24] In theory, imposing vicarious liability on owners protects victims while subjecting owners to minimal costs.[25] The problem arises when a firm in a strategic alliance, such as a partner, is not the "owner" and does not exercise control sufficient to raise it to the level of an "owner," but yet still incurs liability because it has some minimal level of control. In that situation, the firm is vicariously liable without the ability to mitigate the liability

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[17] Alan O. Sykes, *The Boundaries of Vicarious Liability: An Economic Analysis of the Scope of Employment Rule and Related Legal Doctrines*, 101 HARV. L. REV. 563, 563 (1988).

[18] *Id.*

[19] Alan O. Sykes, *The Economics of Vicarious Liability*, 93 YALE L.J. 1231, 1231 (1984); *see also* John L. Hanks, *Franchisor Liability for the Torts of Its Franchisees: The Case for Substituting Liability as a Guarantor for the Current Vicarious Liability*, 24 OKLA. CITY U. L. REV. 1, 15-16 (1999) (stating that generally a plaintiff must show a causal linkage between the defendant's act and the plaintiff's injury, but that vicarious liability deviates from this general principle).

[20] Sykes, *supra* note 19, at 1231.

[21] Ribstein, *supra* note 10, at 411 (additionally noting that economic and legal definitions of a firm are imprecise).

[22] *Id.*

[23] *Id.*

[24] *Id.* at 414 (noting that firms may also have management, profit-sharing, and fiduciary obligations under agency and partnership default rules).

[25] *Id.* at 411 (stating that the owners' control enables them to take loss-avoidance measures, while profit sharing gives them incentive to do so carefully).

because it does not have control in the alliance sufficient to allow it to take risk-reducing measures.

An essential element in the principal-agent relationship, in which vicarious liability is imposed on the principal, is some degree of control by the principal over the conduct of the agent.[26] If a strategic alliance is a partnership, in that the member firms are partners and thus are both principals and agents of each other,[27] determining who is in control becomes complicated.[28] "[T]he effects of vicarious liability on resource allocation often depend on the ability of principals to observe the loss-avoidance behavior of their agents."[29] Therefore, the risks of vicarious liability can be minimized where the principal controls the behavior of an agent. When control is difficult to discern, the ability to minimize the effects of vicarious liability is difficult because a firm not expecting to be liable for its ally's debts will not seek indemnification and insurance until after the liability has arisen. Thus, it is questionable whether vicarious liability should be imposed on a firm in a strategic alliance when the ability to control is difficult to detect.

When structuring the strategic alliance, liability should not be the primary reason for choosing one form of venture over another.[30] If the alliance is structured properly, limited liability can be achieved whether the alliance is a general partnership or a contractual joint venture.[31] Also, firms have the ability to allocate liability contractually ex ante, but doing so can lead to significant transaction costs. Vicarious liability cannot be limited without this proper structuring or contracting because it is imposed by common law governing such enterprises. For example, the nature of a joint venture is such that any negligence on the part of one party may be imputed to the other, thereby allowing a third person to recover an entire claim against any member of the joint venture.[32] This liability is imposed when the joint venturer is acting within the scope of the venture.[33] The risk may be shifted by a promise to insure or indemnify the other party.[34] An absence of these contractual limi-

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26 Herbert B. Chermside, Jr., Annotation, *Vicarious Liability of Private Franchisor*, 81 A.L.R. 3D 764, 769 (1977) (citing 3 AM. JUR. 2D *Agency* § 2 (1936)).

27 Ribstein, *supra* note 10, at 412.

28 *Id.* (noting that control is more ambiguous in partnership than in agency).

29 Sykes, *supra* note 19, at 1245.

30 David Ernst & Stephen Glover, *Tug of War: Combining Legal and Business Best Practice*, *in* STRUCTURING, NEGOTIATING & IMPLEMENTING STRATEGIC ALLIANCES 37, 42 (PLI/Corp. 2001) (analyzing the lawyer's perspective in structuring an alliance).

31 *Id.*

32 46 AM. JUR. 2D *Joint Ventures* § 42 (1962).

33 *Id.*

34 *Id.*

tations can lead to unexpected liabilities for a firm in a joint venture as well as for firms in other forms of strategic alliances.

There are, however, significant transaction costs to risk-sharing agreements.[35] Thus, while it may be in a firm's best interest to allocate liability, it may be more profitable not do so.[36] This is primarily due to costly negotiations and drafting. Additionally, not allocating liability allows for more flexibility in the venture, which is essential for success.[37] A firm must still be able to act to minimize liability from the activities of the strategic alliance, and therefore, there must be some way for a firm to determine the extent to which it will be vicariously liable for the conduct of its ally. A firm can only act to minimize liability when it has an expectation that it can be vicariously liable for the acts of its ally. The question then becomes: In what circumstances within a strategic alliance will a firm expect liability based on the conduct of its ally?

II. TO WHAT EXTENT SHOULD A FIRM BE VICARIOUSLY LIABLE IN A STRATEGIC ALLIANCE?

In determining the extent to which a firm should be vicariously liable in a strategic alliance, the predominant determinant ought to be the level of control that the firm has in the relationship. "Control is the underlying element that assures the coordinated integration of the activities of the group . . . ."[38] In a strategic alliance, firms may share control to varying degrees, ranging from the full power to command to lesser degrees of influence.[39] The amount of control exerted is a fact that must be evaluated in light

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[35] Sykes, *supra* note 19, at 1245.

[36] *Id.*

[37] Fraidin & Lelutiu, *supra* note 1, at 873.

[38] Blumberg, *supra* note 3, at 420.

[39] *Id.* at 423. Blumberg illuminates the concept of shared control in the corporate context as having at least six different levels of the power to control:

> (1) [i]nvolvement in a group that by acting in concert has the power to elect a majority of the board of directors of a corporation; (2) involvement in the management of the subsidiary (or controlled) corporation, including actual participation in the tort, statutory violation, or other corporate acts of the subsidiary giving rise to alleged liability; (3) involvement in the management of the subsidiary including participation in day-to-day affairs but not in the subsidiary's acts giving rise to alleged liability; (4) general involvement in the management of the subsidiary but not including day-to-day affairs; (5) no involvement in the management of the subsidiary, but having a veto over actions of the parent, including those affecting the subsidiary and its operations; and (6) no involvement in the management of the subsidiary, but having a position disposing the management of the parent to consult it and to take its views into account in determining actions of the parent affecting the subsidiary and its operations.

Id.

of the law in the particular area[40] – for example, joint venture and franchise law. Different entities should not be treated identically, especially since the choice of entity decision is given careful thought and could be frustrated if courts disregard the distinctions.[41] However, where vicarious liability is concerned, a consistent test is useful to firms for planning purposes.

When the parties have properly structured the alliance and allocated liability contractually, the extent to which a firm is vicariously liable should be clear. It is when the structuring of the alliance and the contracting among the firms fail that the vicarious liability of a firm in a strategic alliance should be determined by the amount of control. Since contracts in strategic alliances are often incomplete,[42] a mechanism is needed for determining whether a member firm should be vicariously liable. Indeed, it may be better to have an alliance that is less structured and more flexible with regards to control and ownership because those alliances are statistically more likely to lead to a successful venture.[43] Further, it has been said that "[w]here parties will need to cooperate and to trust each other after signing, the tendency of hard, protracted bargaining over details to defeat this goal must be counted among the costs."[44] Thus, where control and ownership are not clearly defined, the courts should look to the extent of control in ascertaining the vicarious liability of a firm for its ally.

It also has been said that "[c]ontrol plays a crucial role in the application of enterprise principles wherever they have been adopted in U.S. law."[45] Control is a fact-specific concept that must be evaluated within the dimensions of the applicable area of law.[46]

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[40] *Id.* at 424.

[41] Dent, *supra* note 1, at 87 (noting that the respect due to legislatures counsels against disregarding statutory differences).

[42] *Id.* at 85. Dent argues that courts mistakenly assume that strategic alliance contracts are complete because they believe that (1) the allies are usually large firms and sophisticated, (2) strategic alliances are important transactions that are expected to be carefully negotiated, and (3) the contracts are large and complicated. *Id.* The presumption fails, Dent argues, because businesses may lack experience with strategic alliances, lawyers may know little about such alliances because there is not a specialized bar for strategic alliances, and the parties to alliances are often cash starved firms. *Id.*

[43] Fraidin & Lelutiu, *supra* note 1, at 873 (stating that less structured and more flexible ventures are often preferred).

[44] Dent, *supra* note 5, at 78.

[45] Blumberg, *supra* note 3, at 424.

[46] *Id.* Blumberg argues:

> [C]ontrol is a doctrine whose significance in the application of enterprise principles attributing legal rights or imposing legal obligations . . . depends on the global context (the juridical area of law under consideration, that is statutory or common law), the general context (the particular statute or branch of common law), and the particular context (the particular aspect in issue) in which it arises.

Id.

In strategic alliances, control is often shared in the sense that more than one firm has or exercises control.[47] The determination of the amount of control necessary to establish liability must be made in accordance with the general policies of the area of law in question and the specific context in which it is being applied.[48] In the context of strategic alliances, vicarious liability should only be imposed when the control is such that the firm can expect to be liable and can therefore minimize the potential liability ex ante. Expectation does not simply require that a clear test be promulgated; rather, a test that is fair and efficient in imposing vicarious liability is needed. Expectations can be met by viewing control narrowly as opposed to broad control over the operations of the ally firm.

When ascertaining the extent to which a firm exercises control, courts should look to whether the firm has the right to control the means of performance.[49] That is, courts should focus on whether the firm had the power to control the specific activity which led to the creation of the liability, whether it is a tort or an unauthorized contract. If the test for vicarious liability in the strategic alliance was simply that a firm must exercise some control in order to be held vicariously liable, then the firm would not only be subject to claims that it did not bargain for or foresee, but also for claims that it did not have the ability to minimize ex ante. Such a test is both inefficient and unfair compared to the right to control test.

To illustrate, suppose that a restaurant franchisee, Firm A, is liable to a customer for serving adulterated food that caused her to be injured. This adulterated food was prepared using a process that Firm A developed. Suppose Firm B, the franchisor, does not have the right to control the processes used by its franchisees, but does have the right to control other aspects of Firm A. Firm B, under this test, should not be vicariously liable because it did not control the specific activity that caused the harm. If Firm B had control over the food preparation process, it could have taken steps to prevent such an injury and minimize its liability. To take this hypothetical one step further, suppose Firm B had control over the day-to-day operations of Firm A. However, day-to-day operations, as defined in the contract, do not encompass food preparation. Thus, Firm B did not expect to be liable for this activity and did

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[47] *Id.*

[48] *Id.*

[49] *See* Michael R. Flynn, *The Law of Franchisor Vicarious Liability: A Critique*, 1993 COLUM. BUS. L. REV. 89, 91 (1993) (stating that in an agency relationship, the principal has the power to control the means of performance, while in an independent contractor relationship, the principal can only control the result of the performance).

not take steps to minimize its liability, and therefore, it is unfair to hold Firm B vicariously liable. Further, if it were some other non-essential business activity that caused the harm, then it may not be foreseeable that it is included in the day-to-day operations of Firm A. Thus, imposing vicarious liability, in the absence of the right to control, is inappropriate.

The right to control test is efficient because it is possible that transaction costs, both negotiation and enforcement costs, may make allocating liability by contract more expensive and therefore, inefficient.[50] Negotiation costs can be especially significant "if the likelihood or magnitude of a given wrong is small in relation to the value of the agency of the parties."[51] This, of course, assumes that the firms in an alliance are aware that they may be treated as being in a partnership – a principal and an agent of each other – prior to forming the alliance.[52] Enforcement costs can be high when a principal has a right of indemnity against the agent.[53] Since contracting to assign liability may be inefficient, allocating liability using a mechanism, such as the right to control the conduct, is desirable.

Vicarious liability for a given wrong is most likely inefficient where an enterprise does not cause the wrong and cannot reduce the probability of the wrong.[54] Imposing vicarious liability in these circumstances may lead to increased costs that can affect the firm and ultimately consumers because firms may pass the costs on to consumers in the form of increased prices. It is only where a firm "can dissuade wrongdoing at little or no cost through the adoption of incentives that affect the behavior of potential wrongdoers, the imposition of vicarious liability can motivate the adoption of such incentive devices."[55] This Comment posits that these

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[50] Sykes, *supra* note 19, at 1242-43.

[51] *Id.* at 1242.

[52] Strategic alliances, and particularly joint ventures, are creatures of contract. Fraidin & Lelutiu, *supra* note 1, at 872. Scholars writing on the subject have noted that by resorting to the joint venture form, the parties are able to contemplate problems in advance and resolve them ex ante by negotiation. *Id.* This does, however, overlook that an important advantage of the joint venture form is the ability to be flexible and adapt to changing market conditions. *Id.* at 873.

[53] Sykes, *supra* note 19, at 1243.

[54] Sykes, *supra* note 17, at 575. Sykes discusses these two inefficiencies in terms of vicarious liability of an employer for the acts of its employees. *Id.* This Comment suggests that these two inefficiencies are also present when vicarious liability is imposed on a firm in a strategic alliance. With regard to the first inefficiency, if the alliance does not cause the harm, then the conduct is not within the scope of the alliance and an ally firm should not be liable for such acts. As to the second inefficiency, if a firm cannot reduce the probability of the wrong, then to impose liability upon it vicariously would be to impose costs that they have no ability to reduce ex ante.

[55] *Id.* at 578-79 (discussing the application of vicarious liability outside the employment relationship).

circumstances exist only where a firm can expect to be vicariously liable, which will be the case where the firm has a right to control the specific conduct that gave rise to liability.

The right to control test is also fair because if a firm has the right to control the acts of its ally, then it is in the best position to prevent the liability from arising, assuming that the conduct is within the scope of the alliance. Moreover, the right to control test does not allow a firm to avoid liability when it can control the specific conduct that leads to liability. For instance, an agreement may state that Firm A is independently contracting Firm B.[56] Firm A, however, retains the right to control a particularly hazardous part of the undertaking.[57] As a result of the independent contractor relationship, Firm A can avoid liability when Firm B causes damages to someone or something while carrying out its duties during the hazardous part of the task.[58] In this situation, it would be fair to hold Firm A liable because it had the right to control how Firm B performed its duties.[59]

Therefore, a firm should be vicariously liable for the conduct of its ally in a strategic alliance if it has the right to control the specific actions of the ally, and the ally is acting within the scope of the alliance. Only then is it fair and efficient to impose such liability on a firm. When a firm has the right to control the specific conduct of its ally, it can expect to be liable and will take steps to minimize liability in advance. This reasoning comports with a firm's expectations when it enters into an alliance and does not contractually allocate liability.

III. CONTROL AT WORK IN STRATEGIC ALLIANCES

This section, by focusing specifically on joint ventures and franchises, both of which are prone to claims involving vicarious liability, examines the different ways control is used by the courts to determine the vicarious liability of firms in strategic alliances. The purpose of this section is to illustrate the inconsistency of the courts in using control as a determinant of vicarious liability in strategic alliances.

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[56] Jackson v. Standard Oil Co., 505 P.2d 139, 144 (Wash. Ct. App. 1972) (using this hypothetical).

[57] *Id.*

[58] *Id.*

[59] *Id.*

A. Joint Ventures

A joint venture is "a collective undertaking by two or more parties to conduct a business operation separate from their own operations."[60] Joint ventures may be formed for a variety of purposes.[61] Unless the joint venture is in the corporate form, such an undertaking is treated as a partnership organized for a limited time and purpose and is governed by analogy to partnership principles.[62] Partnerships and other organizational forms lock the venturers into strong partnership-type co-management default rules and strong fiduciary duties.[63] Courts generally treat a joint venture organized as a separate corporation under corporate law, and not under principles for non-incorporated joint ventures.[64] Thus, when the alliance is structured in the corporate form, the uncertain partnership principles will not apply.

Courts apply different tests when determining whether a joint venture exists such as to give rise to vicarious liability. Courts have considered varying degrees of control in these tests, some requiring equal control. In *Estate of Hernandez v. Flavio*,[65] the Arizona Supreme Court stated that among the elements of a business joint venture is an equal right of control.[66] The court tempered this requirement by stating that each joint venturer must share "to some extent" in the control of the joint venture.[67] A Washington court, in *Adams v. Johnston*,[68] stated that a joint venture does not arise unless, among other things,[69] the firms have an

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60 Blumberg, *supra* note 3, at 462-63.

61 ALAN S. GUTTERMAN, CORPORATE COUNSEL'S GUIDE TO STRATEGIC ALLIANCES 11.001 (1997) (stating that joint ventures may be formed "to conduct research and development work on new products or technical applications, to manufacture or produce various products, to market and distribute products and services in a specified geographic area, or to perform some combination of the aforementioned functions").

62 Blumberg, *supra* note 3, at 463.

63 Ribstein, *supra* note 10, at 417.

64 Blumberg, *supra* note 3, at 463.

65 930 P.2d 1309 (Ariz. 1997). The court addressed the issue of whether pledges of a fraternity were members of a joint venture to provide alcohol to minors. *Id.* at 1312. Though the court acknowledged that joint ventures are generally commercial in nature, it stated that joint venture theory is not limited to business joint ventures. *Id.* The court held that the evidence was insufficient to give rise to a joint venture. *Id.* at 1313.

66 *Id.* at 1312 (citing Tanner Cos. v. Superior Court, 696 P.2d 693, 695 (Ariz. 1984)) (claiming that the other elements of a joint venture are an agreement, a common purpose, a community of interest, and participation in profits and losses).

67 *Id.* at 1313 (stating further that "it is sufficient that a venturer has some voice or right to be heard in the control and management of the venture").

68 860 P.2d 423 (Wash. Ct. App 1993). The court dealt with the issue of whether a medical center was vicariously liable for the acts of a doctor, who was an employee of a unit within the center. *Id.* at 430. The court ultimately found that no joint venture relationship existed, and thus, the medical center was not vicariously liable. *Id.* at 430.

69 The other elements, according to the court, are a common purpose and intention to act

equal right to a voice accompanied by an equal right of control.[70] Similarly, a Missouri court, in *Ritter v. BJC Barnes Jewish Christian Health Systems*,[71] stated that "[i]n order to form a joint venture the parties must have equal control over the enterprise."[72] This requirement of equal control is troublesome for two reasons. First, it seems inflexible because equal control is a specific amount of control, not appearing subject to variation. Second, there seems to be no way to quantify the control. It could be broad control over the enterprise or control over the specific activity. Although two firms may have equal control over the enterprise, they may not have equal control over the activity that caused the injury.

Courts in other jurisdictions have been more flexible about the control required for a joint venture to exist. For example, the United States Court of Appeals for the Eleventh Circuit, in *Williams v. Obstfeld*,[73] applying Florida law, found that a joint venture, like a partnership, requires joint control or right of control.[74] Courts have applied similar control tests in other jurisdictions.[75] A court in Illinois focused the control test in *Behr v. Club Med, Inc.*,[76] stating that for purposes of vicarious liability, a joint venture requires, among other elements,[77] "a right to joint control and management of the property used in the joint venture."[78] This test is problematic because control over property in general does not mean that a joint venturer had the right to control the conduct that resulted in liability. Thus, a firm can be vicariously liable simply

as joint venturers, and a community of interest. *Id.* at 611.

[70] *Id.*

[71] 987 S.W.2d 377 (Mo. Ct. App. 1999). The court determined that there was no joint venture, and thus no vicarious liability between BJC and a hospital. *Id.* at 388.

[72] *Id.*

[73] 314 F.3d 1270 (11th Cir. 2002). The court concluded that there was no joint venture, and thus no vicarious liability, as there was no joint control or joint right to control the business. *Id.* at 1276.

[74] *Id.* at 1275-76 (stating that the other elements are a common purpose, a joint proprietary interest in the subject matter, and the right to share profits and the duty to share losses).

[75] *See* Stevenson v. Rochdale Inv. Mgmt., Inc., 2000 U.S. Dist. LEXIS 13110, at *27 (N.D. Tex. Sept. 7, 2000) (stating that under Texas law a joint venture requires, among other things, "a mutual right of control or management of the enterprise"); Stallings v. Sylvania Ford-Mercury, Inc., 533 S.E.2d 731, 734 (Ga. Ct. App. 2000) (stating that a joint venture is created when two or more people contribute their property or labor in a joint undertaking for profit, "with rights of mutual control," provided that the arrangement does not establish a partnership); Farm-Fuel Prods. Corp. v. Grain Processing Corp., 429 N.W.2d 153, 156 (Iowa 1988) (stating that a joint venture requires, among other elements, "a mutual right to control").

[76] 546 N.E.2d 751, 760 (Ill. App. Ct. 1989) (dealing with the issue of whether a joint venture existed between a resort where the plaintiff allegedly sustained injuries and another company as a result of marketing the vacations). The court held that it did not have to address the issue because the pleading was defective. *Id.* at 760-61.

[77] The other elements include a community of interest in the purpose of the joint venture, and a right to direct and govern the policy and conduct of the other joint venturer. *Id.* at 760.

[78] *Id.*

because it can control assets in the venture which may be wholly unrelated to the conduct and miles away from the place where the injury occurred.

Control, by itself, is typically not determinative as to whether a joint venture exists; at least one jurisdiction does not even require joint control as an element of a joint venture.[79] Control, however, should be emphasized when it comes to imposing vicarious liability on a joint venturer. The act of entering into a joint venture should not automatically give rise to vicarious liability. Such a result would be direct liability, in effect, and the conduct that the firm would be liable for would be the act of entering into the joint venture. Control over the activity that caused the harm ensures that there is a connection between the conduct that gave rise to the liability and the firm, so that the liability can be prevented and possibly minimized.

B. Franchises

In franchises, the franchisor faces a difficult task. It must exercise sufficient control over the franchisee to protect the franchisor's national identity, while at the same time avoiding a degree of control that will render it vicariously liable for the acts of the franchisee.[80] The test for vicarious liability of the franchisor has generally focused on the extent of control it can exercise over the franchisee.[81] A franchise, however, is not an agency relationship or a relationship between two independent contractors.[82] A franchise sets out "a detailed scheme of control between two autonomous businesses."[83] Courts have forced the franchisee into either an agency relationship or an independent contractor relationship.[84] This is problematic because the nature of a franchised good or service implies some, but not total control over the means of performance.[85] The test urged in Part II solves this problem because it requires the franchisor to actually have the right to control the conduct that gave rise to the liability.

The analysis courts use to determine whether a franchisor has control sufficient to give rise to vicarious liability for the acts of

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[79] *See* Edwards v. Price, 550 P.2d 856, 859 (Colo. 1976) (stating that the criteria of a joint venture are: "(1) joint interest in property among the alleged joint venturers, (2) express or implied agreement to share in profits or losses of the venture, and (3) actions and conduct showing cooperation in the project").

[80] Chermside, *supra* note 26, at 769.

[81] *Id.*

[82] Flynn, *supra* note 49, at 90.

[83] *Id.*

[84] *Id.* at 91.

[85] *Id.*

the franchisee varies greatly among jurisdictions.[86] At least one court's analysis of whether a franchisor had control over the franchisee was internally inconsistent. In *Viches v. MLT, Inc.*,[87] the Michigan court stated that a franchisor's vicarious liability for the torts of its franchisees depends on whether a principal-agent relationship exists, and in so determining, a court must assess whether the principal had a right to control the agent's actions.[88] However, the court then stated that the question is whether the franchisor controls the day-to-day operations of the franchisee.[89] This reasoning is inconsistent because the determination as to whether a principal-agent relationship exists initially focuses on control of the agent's specific *actions*, while the inquiry is later focused on control of the *day-to-day operations*. Control over day-to-day operations may or may not entail control over the specific action in question, and to presume that it does is inconsistent with the initial focus. This inconsistency is representative of the conflicting views of what constitutes control sufficient to give rise to vicarious liability in the franchisor-franchisee relationship.

Some courts utilize a control test similar to the one that this Comment advocates. These courts look to whether the franchisor has control over the actions of the franchisee or its employees that led to liability. A Texas court, in *Cole v. Century 21 Real Estate Corp.*,[90] best spells out what should be required in order to make a franchisor vicariously liable. The court stated that to determine whether a principal is vicariously liable for the conduct of an agent, "the key question is whether the principal has the right to control the agent with respect to the details of that conduct."[91] The court reasoned that "[i]f there is no right of control over the matters material to the pending lawsuit, there is no agency relationship as to those matters."[92] Another case that took a narrow view of the control that is required was the New York case *Wu v. Dunkin'*

[86] *See id.* (noting that courts attach different weight to certain indicia of control, as evidenced by the fact that, in a few jurisdictions, certain elements of control, such as the right to specify operations, are dispositive, while other courts are interested in the potential for control, and others yet are concerned with actual control).

[87] 127 F. Supp. 2d 828 (E.D. Mich. 2000).

[88] *Id.* at 832.

[89] *Id.*

[90] 2000 Tex. App. LEXIS 8156 (Dec. 7, 2000). This case dealt with the issue of whether Century 21 could be liable for claims against its franchisee for intentional interference with prospective contracts, defamation, common-law fraud, and statutory violations. *Id.* at *2. The court ultimately concluded that the franchisor was not vicariously liable. *Id.* at *8-9.

[91] *Id.* at *6 (citing *State Farm Mut. Auto Ins. Co. v. Traver*, 980 S.W.2d 625, 627 (Tex. 1998)).

[92] *Id.* The court also stated that in making the determination, it looks to the franchise agreement to determine the right of control. *Id.* at *7.

Donuts, Inc.,[93] where the court held that a franchisor is vicariously liable where it exercises considerable control over the franchisee and the specific instrumentality at issue.[94] The *Wu* court noted that retaining a right to enforce standards or to terminate an agreement for failure to meet specified standards is not sufficient control.[95] Moreover, a right to reenter the premises and inspect did not give rise to a legal duty.[96] Though focusing on the control exercised and not on the right of control, the court illustrates that a vague right to enforce standards is not enough for a firm to be vicariously liable. These cases demonstrate that a narrow view on whether a franchisor has control over a franchisee, such that it may be vicariously liable, comports with the idea that no agency relationship exists where the franchisor does not have the specific right to control the conduct or performance of the franchisee.

At least one court has defined control more broadly, looking at whether the franchisor controls the day-to-day operations of the franchisee. The Michigan court in *Ciofo v. Shock*[97] stated that "a franchisor must have the right to control the day-to-day operations of a franchise in order to establish an agency relationship."[98] The court further found that such a relationship is not created where the franchisor merely retains the right to set standards regarding products and services, or has the right to regulate advertising.[99] This approach, followed by courts in other jurisdictions,[100] is troublesome because it does not focus on whether the franchisor could control the specific conduct that led to liability. To hold a franchisor liable when it did not have the right to control the conduct, but did have a vague right to control the day-to-day operations, is sim-

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93 105 F. Supp. 2d 83 (E.D.N.Y. 2000), *aff'd*, 2001 U.S. App. LEXIS 2544 (2d Cir. Feb. 20, 2001). The issue presented was whether Dunkin' Donuts could be liable for a rape that occurred on the franchisee's premises. *Id.* at 84. The court found that there was no evidence in the record that Dunkin' Donuts exercised actual control over the security measures taken by its franchisee, and thus was not vicariously liable. *Id.* at 85.

94 *Id.* at 88.

95 *Id.*

96 *Id.*

97 1997 Mich. App. LEXIS 1676 (May 16, 1997). The court dealt with the issue of whether the franchisor was vicariously liable for injuries sustained by the plaintiff when the franchisee's employee struck him from behind while delivering pizzas. *Id.* at *1. The court found that there was no evidence that the franchisor had the requisite control. *Id.* at *5-6.

98 *Id.* at *4.

99 *Id.*

100 Flynn claims:

> [C]ourts consider control over day-to-day operations as a proxy for control of the means of performance. Accordingly, in a franchise relationship, the issue of vicarious liability turns on whether the franchisor's control over the day-to-day operations of the franchisee is so extensive that the franchise relationship is really one of agency.

Flynn, *supra* note 49, at 91.

ply not what the franchisor bargained for when it entered into the alliance. If a firm is to be liable when it has day-to-day control, then vicarious liability is seemingly endless. Surely there are some instances where a firm should not be liable, such as when an employee is not acting within the scope of her employment.

Some countervailing considerations suggest that franchisors should be vicariously liable for the conduct of the franchisee, especially with regard to tortious conduct. Imposing liability on franchisors encourages them to monitor and discipline franchisees so that they take appropriate action to avoid unnecessary risks.[101] Imposing vicarious liability on the franchisor also provides an incentive to assure that the franchisee is covered by liability insurance that, "at the margin, equates the expected benefit to the franchisor of an additional unit of insurance with the cost to the franchisee to purchase the marginal unit of insurance."[102] Despite these justifications for imposing vicarious liability on the franchisor, the imposition of vicarious liability in all cases is simply unfair to the franchisor that cannot anticipate being liable for certain activities not within its control. Therefore, it must be where the franchisor has control over the acts of the franchisee that liability ensues.

CONCLUSION

There are many factors a firm must consider when deciding whether to enter into a strategic alliance, but vicarious liability for the acts of its ally may not be one of them. Therefore, liability often comes as a surprise because there was no expectation of it and there may not be a contractual provision to govern such a situation. When there is no contractual allocation, the tests for imposing vicarious liability vary among jurisdictions and from one type of strategic alliance to the next. These tests differ over the degree of control necessary to impose vicarious liability.

To be fair and consistent, the test for vicarious liability should be whether the firm had the right to control the specific activity that led to the liability. If a firm has the ability to control the specific conduct, it is in the best position to prevent the liability from arising. Conversely, if a firm does not have the right to control, then it will not expect the liability to be imposed upon it and there-

[101] Hanks, *supra* note 19, at 18 (arguing that franchisors are in the best position to perform these functions because they know the types of risks to which franchisees, their customers, and third parties are exposed).

[102] *Id.* at 24. Hanks further argues that at lower levels of insurance there is possibly a negligible cost to the franchisor because the franchisee may be willing to purchase insurance without being urged to do so by the franchisor. *Id.*

fore cannot minimize the losses. This right to control test is fairly easy to determine; one just needs to look at the contract and the surrounding circumstances of the strategic alliance. It can also be applied consistently, thereby comporting with the parties' expectations when entering into a strategic alliance. Accordingly, the right to control is the appropriate tool for determining whether a firm in a strategic alliance is vicariously liable for the conduct of its ally.

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