CHAPTER 1

The Elements of a Franchise Relationship

I. Introduction

What’s in a name? Courts reviewing the aftermath of a broken business relationship that involves a trademark, a fee payment, and a marketing plan will scrutinize that relationship for indicia of a franchise, whether or not the parties themselves give it that name. But of course the inquiry is not that simple, because the Federal Trade Commission and the states may differ in the way they define these elements of a franchise relationship, or may add other elements, such as a community of interest, to the mix.

This past year, the question of whether a business arrangement actually constituted a franchise arose in courts’ review of a variety of agreements, including those governing the operation of spas, the sale of automobiles, the distribution of food, the management of golf courses, and the sale of walk-in bathtubs. The final disposition of these cases varied widely as the courts applied each case’s unique facts to each statute’s unique provisions, in an exercise that sometimes provided surprising answers to the question, “Is this a franchise?”

II. Essential Elements of a Franchise

Alleged franchisees are not entitled to the protections of the Indiana Franchise Act and the Indiana Deceptive Franchise Practices Act because they are not Indiana residents, a federal court in Indiana ruled in 7E Fit Spa Licensing Group LLC v. 7EFS of Highlands Ranch, LLC, No. 1:15-cv-01109, Bus. Franchise Guide (CCH) ¶15,833 (S.D. Ind. Sept. 13, 2016), dismissing their counterclaims based on these statutes.
7EFS of Highlands Ranch, LLC and LLC members Gordon and Jane Smith entered into a licensing agreement with 7E Fit Spa Licensing Group LLC, based in Indiana, granting Highlands Ranch the right to use the 7E Fit Spa marks and other intellectual property in a territory in Colorado in return for payment of a 6-percent royalty on gross sales and a $30,000 initial fee. Highlands Ranch also entered into an operating agreement with an affiliate of 7E Fit Spa Licensing. Based on these agreements, Highlands Ranch began operating a 7E Fit Spa health spa, using proprietary equipment and systems owned by 7E Fit Spa Licensing and its affiliates. After the licensing agreement was terminated for alleged breaches, Highlands Ranch changed the name of its spa but continued operating using the same marks, products, services, and proprietary software.

7E Fit Spa Licensing and its affiliates sued Highlands Ranch in Indiana, asserting trademark infringement, breach of contract, and other claims. Highlands Ranch filed counterclaims under the Indiana franchise statutes. 7E Fit Spa Licensing and its affiliates moved to dismiss, arguing that the licensing and operating agreements did not create a franchise and the Indiana franchise statutes did not protect Highlands Ranch because it is not an Indiana resident and does not do business in Indiana.

The court determined that the licensing and operating agreements met the criteria for a franchise under Indiana law because 7E Fit Spa Licensing granted Highlands Ranch the right to engage in the business of dispensing goods and services under a prescribed marketing plan or system; the business was substantially associated with the 7E Fit Spa marks and advertising; and payment of a franchise fee was required.

Nevertheless, the court held Highlands Ranch could not invoke the protection of the Indiana franchise statutes because it did not operate its business in Indiana and was not an Indiana resident. Although Highlands Ranch was formed as an Indiana LLC, for jurisdictional purposes, an LLC’s citizenship is determined solely by the citizenship of its members, the court concluded. Because the members are citizens of Colorado, the LLC itself is a citizen of Colorado; and because residency is a requirement of citizenship, the LLC is also a resident of Colorado, the court held. Accordingly, Highlands Ranch’s counterclaims under the Indiana franchise statutes were dismissed.
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In *Tesla Motors UT, Inc. v. Utah Tax Comm’n*, No. 20150792, Bus. Franchise Guide (CCH) ¶15,947, 2017 WL 1231776 (Utah Apr. 3, 2017), Tesla Motors UT, a subsidiary of Tesla, Inc., appealed to the Utah Supreme Court after it was refused a license to sell new motor vehicles by the Utah Motor Vehicle Enforcement Division and on appeal, by the Utah Tax Commission. In February 2015, Tesla Motors had applied to the Enforcement Division to obtain a new motor vehicle license, as required by Motor Vehicle Business Regulation Act (Licensing Act). But the application was denied on the ground that Tesla UT, if granted a license, would be in violation of the Licensing Act’s prohibition of a license holder selling motor vehicles “for which the licensee does not have a franchise.” Finding that Tesla UT did not have a franchise from Tesla to sell Tesla vehicles, the Enforcement Division denied the application for a dealer license. Tesla UT then entered a “dealer agreement” with Tesla, Inc. that authorized Tesla UT to sell new Tesla vehicles. The dealer agreement recited that it was not creating a franchisor-franchisee relationship, and it prohibited Tesla UT from using Tesla’s trademarks and trade name.

The restrictions in the dealer agreement were likely occasioned by language in Utah’s New Automobile Franchise Act that prohibits a franchisor from owning an interest in a new motor vehicle dealer. Thus, Tesla UT apparently hoped to satisfy the Licensing Act’s requirement that it have a “franchise” to sell new motor vehicles, while steering clear of the Franchise Act’s prohibition of a franchisor having an ownership interest in its franchisee. But the Enforcement Division rejected Tesla UT’s application a second time, finding that either Tesla UT was not actually a franchise, which would violate the Licensing Act, or that Tesla UT was a franchisee of Tesla, Inc., in violation of the Franchise Act. Tesla UT then took an appeal to the Utah Tax Commission, which affirmed the denial of the license, reasoning that “franchise” has the same meaning in both the Licensing Act and the Franchise Act and holding that as a subsidiary of Tesla, Inc., Tesla UT could not obtain a dealer license. Tesla UT appealed to the Utah Supreme Court, arguing that it should be granted a license on both statutory and constitutional grounds. Tesla’s statutory argument was that its dealer agreement with Tesla Inc. satisfied the Licensing Act’s requirement that it have a “franchise” to sell motor vehicles without constituting a franchise under the Franchise Act and running afoul of that Act’s prohibition of a franchisor having an ownership interest in its franchisee.
The supreme court analyzed both statutes and concluded that while they both referred to a franchise, the two statutes provided different definitions for the term. It noted that the Licensing Act’s definition of a franchise “is simply ‘a contract or agreement between a dealer and a manufacturer of new motor vehicles or its distributor or factory branch by which the dealer is authorized to sell any specified make or makes of new motor vehicles.’” By contrast, the supreme court noted that the Franchise Act’s definition of a “franchise” “requires much more than that.” Under the Franchise Act, a franchise exists only where there is an agreement or course of dealing in which “(i) a person grants to another person a license to use a trade name, trademark, service mark, or related characteristic; and (ii) a community of interest exists in the marketing of new motor vehicles, new motor vehicle parts, and services related to the sale or lease of new motor vehicles at wholesale or retail.” Thus, the supreme court rejected the Tax Commission’s view that a franchise for one act constitutes a franchise for the other, concluding, “One could certainly have a franchise under the Licensing Act but no franchise under the Franchise Act.” However, the supreme court held that Tesla UT’s dealer agreement constituted a franchise under both Acts.

The supreme court reviewed the dealer agreement Tesla UT entered with Tesla, Inc. Despite the contractual disclaimer that Tesla was not licensing its trademarks to Tesla UT, the supreme court held that Tesla, Inc. did grant its subsidiary a license to use its marks. As the supreme court observed, “it is quite apparent that Tesla UT’s operation of a dealership is to involve the use of Tesla trademarks. And Tesla has hardly objected; indeed it has given its open support for this use and has even directed it.” Thus, the supreme court held that the dealer agreement “involves at least an implied trademark license....And that is sufficient to satisfy the first element of a ‘franchise’ under the Franchise Act.”

Next, the supreme court turned its attention to the second element of a franchise under the Franchise Act, the “community of interest.” Tesla UT argued it shared a unity of interest with its parent Tesla, Inc., and therefore could not be said to have merely a “community of interest.” The supreme court interpreted Tesla UT’s argument to be that a community of interest could include entities with both unified and disparate interests, while a unity of interest allowed for an identity of interests among its members. But, as the supreme court noted, the core characteristic of a community is its unity. Finding that the second prong of the franchise definition was met, it concluded, “Tesla UT and Tesla are distinct
corporate entities, and their unity of interest could not be clearer with respect to their interest in selling Tesla cars.” Accordingly, the supreme court held that Tesla UT is subject to the Licensing Act’s bar on a franchisor owning an interest in a new motor vehicle dealer.

The supreme court also rejected Tesla UT’s argument that the bar against a franchisor owning an interest in a dealer is unconstitutional. The court first rejected the argument that the Licensing Act violates the Utah Constitution’s Free Market Clause, which states that a free market system should govern trade and commerce. Rejecting the argument, the court characterized the clause as aspirational and too vague to have any justiciable meaning without implementing legislation. Likewise, the court rejected Tesla UT’s equal protection and due process claims, finding that the statutory ownership restrictions were not irrational. Lastly, the supreme court rejected Tesla UT’s “dormant commerce clause” challenge, which hinges on showing that the law imposes an excessive burden compared to its local benefits. The court found that Tesla had failed to support its argument and that, in any event, the arguments had been rejected when the court considered the franchise aspects of the business relationship and the rational basis for the state to regulate such activity.

The court, therefore, rejected Tesla UT’s appeal, holding that Utah dealer and franchise statutes prohibit a wholly owned subsidiary of a motor vehicle manufacturer from obtaining a license to sell the manufacturer’s new motor vehicles in stores in Utah.

Lofgren v. AirTrona Canada, No. 16-cv-1804, Bus. Franchise Guide (CCH) ¶15,909, 2017 WL 384876 (6th Cir. Jan. 27, 2017)(relying on the Michigan Franchise Investment Law, court held that franchisee who purchased second but updated process for cleaning and sanitizing used automobiles had purchased new franchise, which required new franchise disclosure documents) is discussed in more detail in Chapter 2, No. II.

III. Essential Elements of a Dealership

When a federal court of appeals describes the changing and inconsistent positions of the parties (and to some extent, of the district court) as giving the case on appeal “an Alice-in-Wonderland quality,” something has gone awry. In Medina & Medina, Inc. v. Hormel Foods Corp., 840 F.3d 26 (1st Cir. 2016), the culprit was the failure of the parties to reduce their
vague oral food product distribution agreement to writing. What ensued over the life of a 30-year oral distribution arrangement under which Hormel sold its retail refrigerated food products to a distributor in Puerto Rico was years of arguments about the exclusive nature of the agreement and a lawsuit that lasted nearly eight years until it was finally decided by the court of appeals.

In May 1987, following a year of brief discussions at food shows, a meeting at Hormel’s headquarters in Minnesota, and finally a dinner party at a restaurant in San Juan, Puerto Rico, food distributor Medina & Medina discussed and ultimately obtained the right to be Hormel’s distributor of retail refrigerated products in Puerto Rico. The agreement was oral and was one sentence long. At the dinner party in 1999, Hormel’s Vice President of Sales said to Pepin Medina, “Pepin, let’s go ahead, you go ahead and distribute the Hormel product.”

Despite the lack of a written agreement, the parties benefited from their relationship, which, beginning in 1988, allowed Hormel to have a reliable distributor for its products in Puerto Rico and gave Medina exclusive right to purchase and sell Hormel products throughout the territory. But as early as January 1990, the relationship became rocky as Medina began to complain to Hormel that distributors based in mainland USA were selling Hormel products directly into Puerto Rico, undercutting Medina’s business.

The essence of this disagreement, which smoldered for two decades before erupting into litigation, was the parties’ disparate views of the extent of Medina’s exclusive status as Hormel’s Puerto Rico distributor. Medina argued that its distribution agreement with Hormel was for “airtight exclusivity,” meaning that no other entity could distribute Hormel products within or to the island. Hormel countered that although it recognized Medina as its exclusive distributor within Puerto Rico, it would not prohibit it other distributors based outside of Puerto Rico from selling directly to their customers located in Puerto Rico.

Medina’s complaints to Hormel arose in a variety of contexts, including Medina’s concerns that some of its grocery store customers were purchasing Hormel retail refrigerated products from Hormel’s mainland distributors in Florida and New Jersey. Medina complained about Hormel’s food service distributors interfering with its retail sales business and about the sales of party platters to the Costco stores in Puerto Rico. And, after suing Hormel in 2009, Medina complained that Hormel was
wrongfully denying it the right to sell new Hormel items not previously offered in the Puerto Rico market.

While based on the oral agreement with Hormel, Medina’s claims against Hormel relied upon “Law 75,” Puerto Rico’s Dealer Contracts Act. Law 75 protects Puerto Rico distributors from their mainland principals by making it illegal for the principal to impair or act in a manner that is detrimental to the established distributor relationship. However, Law 75 does not create additional distribution rights beyond those agreed to by the parties, but merely imposes on the principal a duty of good faith not to act in a way that is detrimental to the existing rights of the distributor pursuant to the terms of the parties’ distribution agreement.

Medina alleged that Hormel breached the agreement and violated Law 75 by allowing other distributors to sell product into Puerto Rico. Hormel countered that it honored Medina’s right to be the exclusive distributor within Puerto Rico of refrigerated foods, but denied that Medina had the right to block direct sales to the island’s buyers by mainland distributors and argued that Medina’s rights did not extend to every Hormel product. Hormel also raised Law 75’s three year statute of limitations as an absolute bar to Medina’s claims.

Summary judgment motions, initially heard by a magistrate judge with recommendations to the district court, resulted in confusion as to the scope of the court’s orders. The district court’s order on summary judgment found for Hormel on its defense that the three year statute of limitations barred Medina’s claim but, at the same time, found that there was a dispute of fact whether and to what extent Medina was Hormel’s exclusive distributor in Puerto Rico. After a bench trial, the district court issued a final order holding that the statute of limitations did bar Medina’s claim to exclusivity. However, the court agreed with Medina that Hormel’s sales to Costco stores in Puerto Rico breached the agreement.

On appeal, the court of appeals reviewed the entire course of dealing between the parties in an effort to determine the scope of the agreement and whether the statute of limitations served as a bar to Medina’s claims. The disputed evidence, the conflicting arguments of counsel regarding their clients’ positions, and the district courts inconsistent early rulings and final revisions after trial all formed the basis for the court of appeals’ observation that the case had “an Alice-in-Wonderland quality.”

Nevertheless, the court of appeals largely upheld the district court’s final order, applying the three year statute of limitations to Medina’s claims. The court concluded that Medina early and often clearly conveyed
any of the city’s marks. Thus, the court held, the golf pros did not have a claim under the WFDL.

IV. Accidental Franchises

After a licensee of its trademarks failed to pay marketing fees due under its license and marketing agreements, licensor Safe Step Walk In Tub Co. sued to collect the delinquent payments in *Safe Step Walk In Tub Co. v. CKH Industries, Inc.*, No. 15-cv-7543, 2017, Bus. Franchise Guide (CCH) ¶15,940, WL 1050126 (S.D.N.Y. Mar. 17, 2017). The licensee, CKH Industries, filed an answer and 22 counterclaims, alleging that Safe Step was in fact a franchisor and was liable for breach of contract, fraud and deceptive trade practices under state franchise and other statutory and common law causes of action. Safe Step moved to dismiss all the counterclaims for failure to state a claim.

Safe Step manufactures walk-in bathtubs and owns trademarks used in connection with its products. In a series of agreements styled as “Dealership/Licensing Agreements,” Safe Step granted CKH the exclusive right to use the trademarks and market the products in various regions located in the northeastern states, including areas of New York, New Jersey, Massachusetts, New Hampshire, Rhode Island and Connecticut. Safe Step was also obligated to send all sales leads to CKH. In turn, CKH was required to pay a $10,000 “licensing” fee and was required to meet minimum sales requirements. The parties also executed a Marketing Addendum that set forth a fee schedule for advertising for Safe Step’s national and regional advertising, which required CKH to make fee payments on a monthly basis.

The parties’ agreements contained an arbitration clause that required arbitration of “[a]ny controversy, dispute or claim arising out of, in connection with or otherwise relating to any provision of [the] Agreement[s], or to the breach, termination or validity” of the agreements. The agreements further stipulated that Tennessee law should apply to any such proceeding. Yet, Safe Step chose to file its complaint in the Southern District of New York. As the court put it, plaintiff “ignored the arbitration clause when it commenced this action.” CKH likewise did not cite the arbitration agreement when filing its answer and counterclaims, which included claims for the enforcement of the provisions of the various contracts. For its part, the court, in considering CKH’s motion to dismiss, recognized the clear intent of the parties to arbitrate the dispute but concluded that the court would “not sua sponte dismiss or transfer the
action for the parties’ respective failures to follow or to enforce the terms of their agreements.” The court’s stated rationale was that the parties’ agreement as to venue is waivable, but it did not discuss the Federal Arbitration Act’s requirement that arbitration agreements should be enforced with limited exception.

The court next set out to determine whether CKH had stated claims alleging violation of the various state franchise laws. To do so, the court applied Tennessee law to the issue, which the court found would in turn recognize the applicability of the state franchise laws in which CKH operated what it claimed were franchised businesses. The court found that the relevant states (Connecticut, New Jersey, New York, Rhode Island) each required, in order to establish the existence of a franchise, the equivalent of “a marketing plan or system prescribed in substantial part by the franchisor, a “substantial [ ] association] with the franchisor’s [marks],” or “a community of interest [between the parties] in the marketing of goods or services.”

Reviewing CKH’s allegations, the court concluded that CLK’s businesses as a Safe Step distributor “qualify as a franchise under each state’s law,” entitling CLK to pursue state franchise law protections including protection against termination without good cause. (The court also found that “Safe Step has embraced, rather than avoided, the telltale marks of a franchise” under the FTC Rule, but noted CLK had no private right of action under the Rule.) However, the court’s analysis did not extend the protections of the New York and Rhode Island “Little FTC Acts” to CLK. The court reasoned that although the alleged conduct might come within the scope of those acts, which bar deceptive conduct, the alleged conduct did not affect consumers. Since conduct proscribed by the Little FTC Acts must be directed towards consumers, the court held that CLK’s Little FTC Act claims failed to state a cause of action. The court then proceeded to consider the remaining counterclaims of breach of contract, unjust enrichment, promissory estoppel, fraud, unfair competition and injunctive relief, narrowing the scope of some claims and dismissing altogether the claims for the implied covenant of good faith and fair dealing and unfair competition. However, the court granted CLK the right to file an amended pleading to correct pleading deficiencies.