

# Introduction

## Franchise Law as an Academic Discipline<sup>\*</sup>

The publication of this casebook marks a red-letter day for franchising. As you will learn in greater detail in Chapter 1, the concept of franchising can be traced back at least to the Middle Ages, when artisans were allowed to hang their guild signs but had to meet certain criteria before they could practice their trades. As a modern business concept, franchising traces its roots to the Singer Sewing Company's distribution system, and, as a very modern business concept, to the rise of current franchising systems like McDonald's and Holiday Inn. Today there are thousands of franchise companies in the United States, with franchisees ranging in number from a single unit to more than 10,000.

As a regulated method of doing business, franchising dates back to the early 1970s, when the California Franchise Investment Law went into effect. Up to that point, only businesses in certain industries had been subject to franchise regulation, based on their particular business activities rather than their status as franchising entities. The California statute started a wave of regulatory efforts at a more general level—aimed at franchisors across the board rather than in specific industries. Thus, fast-food and hospitality businesses would now be subject to franchise sales regulation, as would construction equipment and wine and beer distribution businesses. By the mid-1970s, franchise sales were regulated in approximately 14 states, and franchise relationships were regulated in approximately 17. After almost ten years of rulemaking efforts, federal regulation came into the picture in 1979, when the Original FTC Rule went into effect. This regulation governed franchise sales disclosures but not franchise relationships themselves.

Thus, by 1979, the patchwork franchise regulatory scheme in the United States had become well established, and there have been no material changes to the scheme since then.

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As an area of academic study, however, franchise law is a new kid on the block. I am not sure which law school first taught the subject, or when, but today, more than 30 years after franchising became a regulated part of the economy, there are only a handful of law schools—maybe ten—that offer franchise law as a course of study.

That is not to say that there has been no study of franchise law. In fact, the opposite is true. Both the American Bar Association Forum on Franchising and the International Franchise Association have published a plethora of papers on various franchise subjects. Both groups also hold annual seminars covering aspects of franchise law and some affiliated areas, as well as recent legal developments in the franchise arena. The Forum also has two publications, the *Franchise Law Journal* and the *Franchise Lawyer*, which publish scholarly pieces about franchise law. In other words, there is no dearth of material on franchise law available to the public, even though this area of the law has been largely ignored by the law schools.<sup>1</sup>

The effect of franchise law not having a significant presence in law schools can be seen in statistics published by the ABA. Those statistics show that the percentage of the Forum's approximately 2,000 members who have been practicing law fewer than five years is smaller than in any of the ABA's other sections and forums. Is this statistic surprising?

To answer this question, one must keep the following in mind: because franchising has not been taught in most law schools, there have been very few students who, when they enter law school or even when they graduate, say, "I want to be a franchise lawyer." Instead, most lawyers who become experts in or knowledgeable about franchise law have received their education and training on the job. Either they have joined law firms that have franchise clients and the firm has had a need for someone knowledgeable in this field, or they have joined companies that operated franchise systems, or wanted to do so. Stated differently, almost all franchise lawyers have been drafted into the field because of actual or recognized demands for franchising services by their law firms or employers. Moreover, not only have the law schools been slow in recognizing franchise law as a discipline, but so have the courts and most law firms.

This hypothesis is supported by a recent decision, *State of Nebraska v. Orr*.<sup>2</sup> Mr. Orr was a well-respected attorney in a small firm in Nebraska. A client knocked on his door one day, asking him to provide the legal work necessary for his company to become a franchisor. Mr. Orr lacked training or experience in franchise law but nevertheless undertook the representation. The court's opinion suggests that Mr. Orr had read franchise agreements and concluded that he was competent to represent the client

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1. Some 27 years ago, the International Society of Franchising was formed. Composed primarily of professors around the world, the Society holds a conference each year at which numerous papers on franchising are presented. Almost all of these papers focus on franchise subjects that are not of a legal nature, and the papers that emanate from these conferences are largely unknown to or, regrettably, ignored by the legal community.

2. *State ex rel. Counsel for Discipline of Nebraska Supreme Court v. Orr*, 759 N.W.2d 702 (2009).

in this endeavor, a conclusion that proved to be wrong. Another lawyer whom Mr. Orr retained to handle his client's trademark work warned Mr. Orr that franchising was a complex area and that he should retain an expert to handle this work as well as the client's trademark needs. But Mr. Orr plodded on with his client's franchise project. The franchise system failed, and ultimately, Mr. Orr was brought before the Nebraska disciplinary board for violating the canons of ethics for that state, specifically those that require a lawyer to be competent in the legal work he performs.<sup>3</sup>

*Orr* is important because it is one of the only judicial decrees recognizing that franchising has become an area of practice unto itself. Why has this judicial recognition taken so long to emerge? It is my belief that the failure to offer franchise law courses by all but a handful of law schools has lowered franchising's legal profile. Given the widespread popularity of franchising as a method of distribution, I find this absence of recognition surprising. A few years ago, I attended my firm's "show and tell" for our summer clerks, which was intended to familiarize them with our firm's practice. The program included an impressive presentation by our corporate and securities group, in which our attorneys overwhelmed the clerks with statistics and the numerous multi-million-dollar deals they had closed. The attorneys named the clients they represented, and those names were unknown to the young attorneys and even to me. Many clients had acronyms that were unknown to the public and offered no indicators of what they did or made.

In contrast, I followed with a presentation about our franchise practice. The financial magnitude of the matters I had worked on during the last 30 years was far less impressive than those previously mentioned, but my matters had involved many brands that were household names. I suggested that, when the summer associates found themselves walking through a certain intersection in Atlanta, they should stop and turn 360 degrees. They would see over a dozen businesses with names of chains I had worked with during my career. The omnipresence of franchise companies should provide, one would think, a strong incentive for many law schools to offer a course on the subject. There is reason to hope that the publication of this casebook will help to prompt many to do so.

## **The Scope of Franchise Law**

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If you peruse this casebook's Table of Contents, you will see several subjects that might make you ask, "Why are they included in this book and as part of a franchise law course?" The answer to this question comes from the fact that the book is both academically and practically oriented.

There is, in fact, a distinct area of law that could be described as "franchise law." It emanates primarily from two sources: regulatory laws and common law principles.

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3. Mr. Orr was censured but did not lose his license to practice law.

It is easy to identify the body of franchise law that stems from the adoption of certain statutes and administrative regulations, many of which were referred to earlier in this Introduction and will be identified in more detail as you proceed through this book and your course. Broadly speaking, these statutes and regulations fall into three categories.

The laws in the first category, which will be covered in Chapters 8, 9, and 10, deal with the formation of the franchise relationship. You might think of the franchise sales process in terms of a mating dance. The franchisor has something to offer: a system that will include one or more trademarks and a method of doing business. The franchisee is seeking a way to invest his or her money and time. The end point of this dance is the execution of a franchise agreement by the franchisor and the franchisee, as well as possibly one or more other documents that spell out the rights and obligations of the parties.

Disclosure has become an integral part of the process of selling many franchises. Prior to executing the franchise agreement and any necessary collateral documents,<sup>4</sup> the prospective franchisee will receive a document referred to as the Franchise Disclosure Document (FDD).<sup>5</sup> The FDD, much like a securities prospectus, is not intended to define the franchise relationship but is supposed to highlight for the prospective franchisee the material rights and obligations of the parties under the franchise agreement. The FDD also provides the prospective franchisee with other critical information about the franchisor and its management, including the market for the product or service under consideration, the track record of the franchises in the system, and the financial condition of the franchisor. The document is not meant to be the end-all, be-all that a prospective franchisee needs to know about the investment under consideration; rather, it is the starting point for the franchisee's due diligence investigation.

A second category of laws, referred to as the "relationship laws," focuses on what a franchisor may and may not do once the franchise relationship has become operational. The activities regulated by these laws vary dramatically from state to state, with the more common provisions regulating a franchisor's right to terminate the relationship or to not renew it upon expiration, conditions imposed by a franchisor on assignments by the franchisee of its rights (and delegations of its obligations) under the franchise agreement, limitations on the franchisor's ability to restrict the sources from which a franchisee may purchase goods and services used in the franchise's operation,

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4. Depending upon the terms of the franchise relationship, the collateral documents might include one or more of the following: a promissory note, a guaranty, a mortgage, a master franchise agreement, a non-compete agreement, or a non-disclosure agreement.

5. Prior to the adoption of the 2007 amendments to the Original FTC Rule, there were two forms of disclosure documents: The Uniform Franchise Offering Circular, or the UFOC, and an FTC Disclosure document. In 2007, the FTC promulgated the FTC Rule (or the "Rule")—an amended version of the Original FTC Rule. In the FTC Rule, the agency essentially merged the two formats together, and the resulting disclosure document is now called a "Franchise Disclosure Document," or FDD. See Chapter 8.

and protection of the franchisee's right to join associations formed to protect franchisee rights. Chapter 11 focuses on the relationship laws.

The laws in the third category govern "business opportunities." These laws, which have been adopted in 24 states, also require disclosure and, in many instances, registration with the state of certain activities involving the offer of sales of rights to open a new business, irrespective of whether there are trademark rights involved in the opportunity.<sup>6</sup> Not all franchises are business opportunities, nor are all business opportunities franchises. But the two concepts do overlap. A more detailed description of these laws will be found in Chapter 12.

Of course, before the statutory and administrative regulatory scheme in this country was created, there existed a body of law governing franchise sales and relationships. The common law treated, and correctly so, the franchise relationship as a contractual one. Rules of contract formation, contract interpretation, the rights and obligations of a party under a contract, and contract enforcement governed franchising prior to the adoption of the statutory regulatory framework. The franchise laws provided a supplement to the common law. They either expanded various notions of contract law, as applied to franchise systems, or altered the common law. For example, in a few states the concept of good faith and fair dealing has been adopted in a franchise statute. Though the concept existed prior to the enactment of these statutes, they constituted a more emphatic way to make clear that the concept applied to a franchise relationship. In other examples, franchise laws reversed what franchising parties had previously been able to do pursuant to freedom of contract principles. For example, under some relationship laws, franchise agreements can no longer be terminated by a franchisor without good cause for the termination and advance notice having been given to the franchisee.

Thus, as is the case with securities laws, today we have a body of law whose substance is unique to franchise systems, backed by a body of common law that applies general principles of contract law to franchises sales and relationships.

But for franchise practitioners, this knowledge is not sufficient for a lawyer to be a "franchise lawyer." As the Table of Contents indicates, a franchise lawyer must be knowledgeable in other areas as well.

One such area is trademark law. By definition, without a trademark affiliation or license between the franchisor and the franchisee, there is no franchise. Boiled down to its essentials, a franchise agreement is, in most cases, a trademark license granting a franchisee the right to use a franchisor's marks and a business system, owned by the franchisor, that allows a franchisee to exploit the marks. With one exception,<sup>7</sup> a trademark license will not, by itself, create a franchise relationship. The generally accepted

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6. But if the seller's mark is federally registered, the sale may not be governed by a business opportunity act. See, e.g., Conn. Gen. Stat. § 36b-61(2) (West 2011).

7. Under the New York Franchise Act, the grant of a trademark license will create a franchise if the grantee is required to pay a franchise fee. See N.Y. Gen. Bus. Law § 681(3) (b) (McKinney 2012).

definition of a franchise requires that a franchisor also provide substantial assistance or impose substantial control over the franchisee<sup>8</sup> and requires that a “fee”—a broadly defined term that includes upfront payments, royalties, and advertising fees, among other things—be paid to the franchisor or its affiliate(s) by the franchisee. The fact that trademarks are an integral part of a franchise relationship means that a basic knowledge of trademark law will be critical for a lawyer to understand franchise law and effectively represent franchise clients.

Antitrust law is another subject with which the renaissance franchise lawyer must be familiar. One who examines the history of franchise law will discover that many of the early disputes between franchisors and franchisees involved antitrust issues. Until recently, pricing controls imposed upon franchisees and restricting their ability to set prices on their own have been a pervasive issue in many franchise systems. Can a franchisor require that franchisees not sell goods or services below a specified price or at a price that does not exceed a certain level? Many other antitrust or antitrust-related issues are involved in the franchise relationship. What can the franchisees say, and not say, with respect to prices in their advertising? Can franchisees among themselves decide what prices or price levels can be charged? Are purchasing co-ops anticompetitive?

The second antitrust principle that frequently affects franchising is tying, or, put simply, whether a franchisor, by granting a trademark license, can force franchisees to buy certain goods and services from the franchisor, one of its affiliates, or other designated suppliers or dictate standards that franchisees must meet when purchasing goods and services. Most of the early disputes between franchisors and their franchisees focused upon franchisor requirements that franchisees purchase some, if not all, of the goods and services necessary to conduct franchised businesses (1) from their franchisors, who could charge prices higher than those charged in open market purchases, or (2) from suppliers who paid hidden rebates or kickbacks to the franchisors.

These issues historically required a lawyer advising a franchisor or a franchisee to know the boundaries of these antitrust concepts as they applied to franchising. These boundaries have been fluid over the last decade or so. The Supreme Court’s antitrust decisions on price controls over the last decade have made antitrust laws significantly less important to franchising. However, as is often the case, the end of one battle may simply be the opening of another. On the issue of vertical minimum price fixing, some states’ attorneys general, who have in the past not been dominant players in opposing minimum resale price restrictions, have aggressively taken the position that in their states the restraints are per se violations of the state antitrust laws. For purposes of those state laws, the attorneys general are rejecting the proposition the Supreme Court endorsed in the *Leegin*<sup>9</sup> case, that the vertical price restrictions should be evaluated

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8. Or, the franchisor must at least be entitled to control the franchisee.

9. *Leegin Creative Leather Products v. PSKS*, 551 U.S. 877 (2007).

under a rule of reason test, rather than being per se illegal. For discussion of the application of the federal antitrust laws to franchising, see Chapter 5.

Mergers and acquisitions is an important subject for lawyers advising franchisors or franchisees. Although many franchisors are in their businesses for the long haul, even they have an eye on how they may grow the system, perhaps by acquiring another franchisor, or exit the franchise relationship at an appropriate time, thus maximizing the return on their investment. Can a franchisor sell its franchise system to anyone without restriction? What obligations do its successors have to its franchisees? Knowing how to leave a franchise system can become just as important to a franchisor as entering the system in the first place. Similar questions arise when the subject turns to the sale of a franchise interest by a franchisee. Chapter 14 covers mergers and acquisitions in franchising.

There are other chapters within this book that, similarly, deal with subjects that are broader than franchise law. The chapters on trade secrets and copyrights fall into these categories. The bottom line, as you will realize when you come to the end of this book, is that the knowledge base of an effective franchise lawyer must transcend the boundaries of franchising.

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## About the Casebook's Contributors

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Most casebooks with which I am familiar are constructed by academics who have spent the primary portion of their careers in teaching environments. This casebook is different. Some of the contributors are full-time faculty members and some have taught franchising in various law schools, but most have been private practitioners for the bulk of their careers. I estimate that, collectively, the practitioners have spent more than 500 years working with clients in the real world and thinking about the kinds of questions that the book explores. They are some of the best and the brightest and the most experienced in the field of franchise law. Their experience, as you will see, brings to this casebook a blend of theoretical and practical perspectives on the legal and policy issues raised by franchising as a business model.

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## Critical Thinking and Policy

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There is a split of opinion as to what law schools should teach and how. A 2012 article that appeared in *The New York Times* suggests that law schools focus too much on theory and not enough on practicality. A more acerbic way to say this is to say that law schools should be trade schools. There is truth to this statement, but the statement should not go unchallenged.

No doubt, one of the purposes of law school is to prepare the law student for the real-world environment. But a second, and even more important, law school function

is to teach students how to think and analyze. Law school should be more than simply a means to pass the bar exam.

There are two important methods that law schools follow to teach their students at a level beyond that of a trade school. The first is case analysis. Judges decide cases based on facts and the law, and applying the law to the facts is no easy feat. To be sure, many cases are not close calls. However, judicial philosophy and a human sense of justice cannot be taken out of judicial decision-making, and they are both factors that can be outcome determinative, notwithstanding the concept of precedent.<sup>10</sup> Consider one of the most famous franchise cases: *Scheck v. Burger King Corp.*,<sup>11</sup> in which the facts showed that the franchisor, Burger King, had opened a new unit in close proximity to a franchised unit owned by Mr. Scheck. The franchise agreement provided explicitly that the franchisee had no protected territory. But the court concluded that the lack of territorial protection did not mean that the franchisor could open a new unit, whether company-owned or franchised, anywhere it pleased, absent express language to that effect. In other words, the franchisor could not knowingly destroy the franchisee's business. The case provides an example of a judge wanting to do what he perceived to be the right thing, despite pro-franchisor language in the agreement. The court ruled in favor of the franchisee on a motion for summary judgment filed by the franchisor and opposed by Mr. Scheck, thus allowing the parties to proceed to trial. On reconsideration, the judge did not waiver, and the case ultimately settled. A substantially identical case, *Burger King Corp. v. Weaver*,<sup>12</sup> was brought before the same federal district court a couple of years later, and the judge who presided reached the opposite conclusion. *Weaver* was later affirmed by the Eleventh Circuit,<sup>13</sup> which thus essentially overruled *Scheck*. (The two cases are discussed extensively in Chapter 13.) Which judge was right and why? What led these judges to go in directly opposite directions? These are the kinds of questions that law schools should ask their students to address. There is more to practicing law than simply regurgitating the results of various precedents.

This casebook is crafted to stimulate this kind of thinking. One might contrast it with the book, *Fundamentals of Franchising*, for which I was the Co-Editor-in-Chief. That book is more like a mini-treatise on franchise law and closely associated subjects, such as antitrust and trademarks. It is designed to give newcomers to franchise law a quick boost in their knowledge in these areas. Although it has been used as a textbook in teaching franchise law at several law schools, it is not designed to teach critical thinking, as is this book. This book's approach to franchise law is quite different.

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10. Law students should be trained to evaluate the relevance of these beyond-the-precedent factors.

11. *Scheck v. Burger King Corp.*, 756 F. Supp. 543 (S.D. Fla. 1991).

12. *Burger King Corp. v. Weaver*, 33 F. Supp. 2d 1037 (S.D. Fla. 1998).

13. *Burger King Corp. v. Weaver*, 169 F.3d 1310 (11th Cir. 1999).



## Policy

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Let me also suggest that when this book is brought into the classroom, there are two other purposes that it should serve. In teaching franchise law, predicting the so-called right answer, as reflected in precedents and statutes, is only one element of becoming a better lawyer. It is, in my view, equally important to ask what the right answer should be. From a contract law standpoint, I believe the *Scheck* case was rightly decided. The contract was clear on its face, but the judge, I sense, felt that the contract language would not produce the right decision from a policy standpoint. The case raised the question of whether, in the absence of bad faith, a franchisor should be able to locate its systems units in a manner that will adversely affect, even destroy, the business of existing franchisees. Such encroachment not only affects the viability of the single unit that is affected by the new store's appearance, but it can ruin the viability of other units owned by the existing franchisee, for the diminishment of the profits of the single unit may end up harming the franchisee's entire business. It leaves a franchisee with less funds to shore up other units whose operations may not be profitable or self-sustaining. Moreover, a franchisee whose unit has been encroached upon may ultimately be forced into bankruptcy, either with respect to that unit or with respect to all of the franchisee's units. This development may have an adverse effect on a franchisor's brand for various reasons, thereby harming not only the franchisor but also the other franchisees in the system. Challenges in life often require deep analysis, not easy, superficial answers. The difference between adequate lawyers and good ones is that the good lawyers, as though playing chess, think several steps beyond their first blush reactions to these challenges in trying to meet them.

And that leads to my final subject: regulatory policy. What the law should be is too simple a way to look at franchise law from a higher altitude. One criticism of U.S. franchise law is that it has evolved like a camel, which is often defined in jest as a horse created by a committee. However, this description, although comic, is very true. As Chapter 1 on the history of franchise law suggests, franchise law was built in numerous steps, many of which were not coordinated by the craftsmen. When the map of franchise regulation was created, federal law was not well-coordinated with existing state law, and the laws of each state were not synchronized with those of other states. The results have been organized chaos. Even now, the definition of "franchise" itself is not consistent among the states. Most states have a three-prong test. Generically, a franchise in all states but New York and Connecticut must involve a trademark, a fee payment, and control by the franchisor over the franchisee's business operation. In New York, however, the definition is two-pronged, requiring only that either (1) the trademark and fee tests be met, or (2) the control test and the fee test be met to make an arrangement a franchise. Connecticut does not require the payment of a franchise fee. In some states, a franchise offering will be subjected to review by state officials before the state will authorize the franchisor to offer units for sale in the jurisdiction.

The review often requires the exercise of discretion and judgment by state officials, which may result in even more challenges for franchisors that have multi-state franchise systems. In other states, there may be no review, or only a lighter degree of state scrutiny. And each state exempts different types of transactions from its registration or disclosure (or both) requirements. An arrangement that might constitute a franchise in state X, and therefore be subject to the state's registration, disclosure, or relationship requirements, might not constitute a franchise in state Y. Given that almost all franchisors want to sell units in more than one, and possibly all, states, is the current regulatory system an efficient way to regulate franchising? Does the degree of protection resulting from these requirements justify the associated costs? If not, what system of regulation would be preferable? Should the various state laws be replaced by a uniform franchise law, designed for adoption by all states? Or should the federal government preempt all state regulation of franchising in or affecting interstate commerce? Whatever its source, should regulation focus only on presale disclosure, or do relationship laws serve a useful purpose? If so, what kinds of relationship laws are needed? What kinds of enforcement mechanisms are appropriate for disclosure and relationship laws? These are questions that the students should be asking each week as they progress through this book, keeping in mind that regulation is created in a social, economic, and political environment.

What often appears to be the right solution is not often achievable in the real world. But, unfortunately, too often these kinds of questions go unasked. Hopefully, after you finish with this casebook and your course on franchise law, you will be one more convert who at least has formed personal views on how the questions should be answered. If this is the case, then the book and your course will have fulfilled their most important purpose.