Franchise Law Journal

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Deadline for 2018 Edward Wood Dunham Rising Scholar Award Announced

The deadline for the 2018 Rising Scholar Award will be Monday, July 16, 2018. To be eligible, entrants must be members of the ABA Forum on Franchising and zero to seven years out of law school. Qualified participants should prepare articles according to the *Franchise Law Journal*’s author guidelines. The submissions will be judged by current and former members of the *Franchise Law Journal* and the *Franchise Lawyer* editorial boards. The current Forum chair will also be consulted and provide input on the selection of the winning article.

The author of the winning article will receive the following: (1) the article will be considered for publication in a future edition of *Franchise Law Journal*; (2) the author will be recognized and presented with a plaque at the Annual Forum on Franchising; (3) the author will receive a small financial award to reimburse in part expenses for traveling to the Annual Forum for the award presentation; and (4) the author’s registration fee for attending the Annual Forum will be waived.

Articles must be submitted to Gary R. Batenhorst, the editor-in-chief of the *Franchise Law Journal*, no later than Monday, July 16, 2018, to be considered in this year’s competition. All inquiries should be directed to: gbatenhorst@clinewilliams.com.

We look forward to receiving the submissions!
From the Editor-In-Chief

Gary R. Batenhorst

When you receive this issue, 2017 will be nearly over. I hope it has been a good year for you; the editors and staff of the Franchise Law Journal wish you all the best for 2018.

It was great to see so many of you at the 40th Annual Forum on Franchising in Palm Desert. The programs and events I attended were excellent. Congratulations to the co-chairs of this Forum, Dawn Newton and Ron Coleman, on a job very well done! Next year’s Forum will be in Nashville, a great city where I have never been, and I look forward to seeing you there.

If attending this year’s Forum has inspired you to become more involved, writing for the Franchise Law Journal is a great way to do that. It gives you an opportunity to contribute to the excellent scholarship that is a hallmark of the Forum and serves as a pathway toward greater involvement and leadership in the Forum. Please email me for a list of our open topics, or better yet come up with a topic of your own that interests you.

I want to remind younger members of the Forum about the Edward Wood Dunham Rising Scholar Award, a writing competition for lawyers who are 0–7 years out of law school. Participants write articles on a franchise or distribution law topic utilizing our existing author guidelines. Entrants can select a topic from our open topics list, but we prefer that authors select their own topics. The deadline for submitting articles for this year’s award is July 16, 2018. The winning article will be considered for publication in the Journal. The author will be recognized at the Annual Forum on Franchising, will receive reimbursement for partial expenses for traveling to the Forum, and the author's registration fee for attending the Forum will be waived.

Now on to the Fall issue, which provides a great variety of articles. We start with A State’s Reach Cannot Exceed its Grasp: Territorial Limitations on State Franchise Statutes by our Associate Editor Dan Oates and his colleagues Vanessa

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Gary R. Batenhorst (gbatenhorst@clinewilliams.com) is a partner in the Omaha office of Cline Williams Wright Johnson & Oldfather, L.L.P, where he focuses on franchising and distribution, business organization, and mergers and acquisitions. He welcomes comments from readers.
Wheeler and Katie Loberstein. They provide an excellent and comprehensive look at the different ways that states deal with the territorial reach of their franchise statutes. Accidental franchises have posed challenges to drafters of distribution arrangements since the advent of franchise disclosure and relationship laws. Paul Fransway provides us a helpful fresh look at this topic in our next article, *Traversing the Minefield: Recent Developments Relating to Accidental Franchises.*

The recent Forum included an excellent program on bankruptcy issues, in which our Associate Editor Jason Binford was a presenter. We deal with these issues in *Location, Location, Location: Effect of the Franchisee’s Bankruptcy on the Franchisor’s Control of Real Estate* by Susan Metcalfe, a very interesting and timely look at issues franchisors face in trying to control the real estate following a franchisee’s bankruptcy. Another challenge for franchisors relates to selective enforcement of post-term non-compete provisions in franchise agreements. *Turning an (Occasional) Blind Eye: Selective Enforcement of Franchise Post-Term Non-Compete Covenants* by Jess Dance and William Sentell provides us with a very well written and interesting look at this topic.

*Franchise Law Journal* articles typically provide a dispassionate look at different sides of franchise law issues. But on occasion we publish articles in which the author conveys a strong, and in some cases controversial, point of view. Several articles on joint employer issues in recent years have taken this approach. Toronto franchise lawyer Peter Dillon has some very strong opinions on his view of the state of Canadian franchise laws, which he has expressed in *Canada: It’s Like Watching a Car Crash in Slow Motion.* As you can glean from his title, Peter is not pleased with the current direction he thinks franchise law is headed in Canada. Some Canadian franchise lawyers may not agree with Peter’s opinions, but we thought our readers would be interested in hearing his point of view.

Our final article in this issue is *Compliance Audits Rule!*, in which Mary Beth Gettins provides us with a helpful look at the important role audits play in franchise compliance programs. We conclude this issue with an excellent selection of Currents edited by Griff Towle, Elliot Ginsburg, and Jan Gilbert, as we continue in our new format of longer summaries of fewer current cases.

In closing, special thanks to Jennifer Dolman, whose term as a Topic and Article Editor expired this year. We have appreciated all of Jennifer’s work on articles by Canadian authors, and she completed her tenure with us by her diligent and very helpful editing of the Peter Dillon article. As always, we hope you enjoy this issue of the *Journal.*
A State’s Reach Cannot Exceed its Grasp: Territorial Limitations on State Franchise Statutes

Daniel J. Oates, Vanessa L. Wheeler, and Katie Loberstein

For a host of reasons, ranging from practical to political to constitutional, states are constrained in the exercise of their regulatory authority. In recognition of these limitations, state legislatures, when enacting franchise laws, crafted various express limitations on the reach of their state’s laws. These laws have remained largely unchanged for nearly fifty years, in stark contrast to the vibrant and constantly evolving marketplace of the U.S. economy. Unfettered access to information on the Internet and reliable methods of instant communication serve to equalize potential information imbalances between franchisor and franchisee, while simultaneously rendering the physical borders between states increasingly irrelevant. As a result, the limitations on the reach of cumbersome state franchise statutes are becoming more relevant by the day.

This Article examines the territorial and constitutional limits of state franchise laws. Part I provides a general history of how and why franchise regulations arose in the various states that enacted them. Part II analyzes the differences in territorial limiting lan-

1. See generally William L. Killion, The Modern Myth of the Vulnerable Franchisee: The Case for A More Balanced View of the Franchisor-Franchisee Relationship, 28 Franchise L.J. 23, 28 (2008) (noting that franchisees today have a wealth of information at their disposal when making purchasing decisions in the marketplace). Indeed, the new franchisee today is far more likely to be a sophisticated, multi-unit operator. Id.
guage adopted by state legislatures and the application of that language by
the courts. Part III considers the constitutional limits that prohibit broad extraterritorial reach of state franchise laws and addresses arguments for adopting uniform territorial limits between the states, particularly in the face of constitutional requirements.

I. A Brief History of Franchise Law in the United States

A. The Franchise Industry Before Regulation

Franchise businesses have existed since the early 1900s in the form of “product distribution franchising” or “traditional franchising.” Yet franchising did not become a hallmark of the American economy until the 1950s. Before that point, fewer than 100 franchisors may have existed in the United States. With the rise of the business format franchise concept, franchise giants like McDonald’s and Domino’s Pizza developed successful business models that they licensed to independent business owners nationwide. The business format franchise model proved wildly successful and, as a result, quickly proliferated throughout various industries in the American market.

The early era of the business format franchise was considered by some to be the “Wild West.” The model generated wealth for many Americans, but the unnaturally fast growth was also creating problems. On May 29, 1970, The Wall Street Journal headline read “Many Franchise Firms Fall on Hard Times After a 15-Year Boom.” As one might expect, the success of the model, and the absence of any regulatory oversight, drew the interest of less-than-savory entrepreneurs. These unscrupulous individuals sought to “make a quick buck at the expense of vulnerable would-be franchisees,” and their unethical practices led to a demand for regulation of franchising at both the state and federal level.

Harold Brown, a franchisee advocate, claimed (without evidentiary support) that franchisees typically “are in their middle years, come from a sheltered

5. Gurnick & Vieux, supra note 3, at 48.
7. Killion, supra note 2, at 5.
10. Id. at 14. One of the most famous examples of this issue was the Minnie Pearl’s Chicken System, which was started by two brothers who sold Minnie Pearl restaurant franchises. They sold franchises for 1,600 restaurants, using the practice of “going public on the strength of earnings based entirely on one-shot franchise fees in hand. . . .” Id. (quoting J. Richard Elliott, Jr., Home to Roost: Excesses of the Fast Food Franchisers Are Catching up to Some, BARRON’S NAT’L BUS. & FIN. WKLY., Sept. 22, 1969, at 5). Unsurprisingly, that franchise bubble burst by 1969, with only 263 of the franchise restaurants operational.
11. Killion, supra note 2, at 5.
existence, and appear to be totally unprepared for a violent change in their life pattern. Many Americans found franchisors distasteful and corrupt by 1970, but they also felt that franchises were critical to American industry. In an effort to address these problems, states began enacting laws to “protect[] franchisees from a lack of information about franchise opportunity” and curb unethical behavior by franchisors.

**B. Federal Regulation**

Amidst the din of public outcry, the Federal Trade Commission (FTC) recognized a need to act on a national level. The proceedings, however, were slow and required public hearings and investigations of allegedly abusive franchise practices. In 1971, the FTC initiated the bureaucratic process of rulemaking, which lasted for seven years and resulted in a franchise regulation that became effective in 1979.

The FTC rule required franchisors to disclose certain material information to franchisees in connection with the sale of a franchise. The express purpose of such disclosure was to correct the “serious informational imbalance” believed then to exist in favor of franchisors against franchisees. To a large degree, the FTC’s requirements were effective. In the years since the rule’s enactment, franchisees’ ability to conduct meaningful due diligence into, and comparison shop between, franchise offerings has been dramatically improved.

**II. The Territorial Limits of State Franchise Laws: Strict, Moderate, and Questionably Broad**

While the FTC slowly turned the bureaucratic wheel on federal regulation, many states were too impatient to wait for a single national policy. As a result, a number of states, beginning with California in 1971, began enacting their own state franchise laws. Perhaps recognizing that the FTC was in the process of adopting a uniform standard for regulating franchise relationships, and further, that franchising was by that time already a nationwide phenomenon, state legislatures reined in the scope of their laws with territorial limitations so as not to overstep their bounds. Quickly, general trends began to emerge in the territorial limitations adopted in state franchise laws. These limitations can be classified as narrow, middle-of-the-road,

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14. *Id.* at 5.


16. *Id.*

17. *Id.*

and broad. These categories and their implications are discussed in greater detail later.

A. The Narrow States

Approximately half of all franchising state statutes contain what can be construed as a narrow extraterritorial limitation.19 In general, these narrow limitations require that, for the franchise statute to apply, the franchisee must maintain a “place of business” that is physically located—or is contemplated to be physically located—within the geographic boundaries of the particular state.

The statutory language for these jurisdictions is very similar and, as a result, there is not much case law or discussion about the scope of the limitations, which is relatively straightforward based on the plain language of the statutes. To the extent there are any differences between the applications of these statutes, the differences arise out of alternative interpretations of what constitutes a “place of business.” Some states have adopted a broader interpretation, in which a place of business constitutes any significant nexus or business connection to the state. For example, the Virginia Supreme Court has held that the Virginia Retail Franchising Act applied to a newspaper distributor franchisee, despite the fact that the distributor did not maintain a fixed physical location in Virginia from which it conducted its business.20 The court reasoned that the distributor’s connection to the state and its assigned territory within the state were sufficient to establish a “place of business” under the Act.21

Other states have adopted a more limited approach in determining what constitutes a “place of business.” In Arkansas, for example, courts require that the franchisee maintain a physical place of business within the state in order for the statute to apply. Under the Arkansas Franchise Practices Act, a place of business is defined as “a fixed geographical location at which the franchisee both displays for sale and sells the franchisor’s goods or offers for sale and sells the franchisor’s services.”22 Accordingly, the Act would not apply to a putative franchisee who is directed to sell the putative franchisor’s products door-to-door.23 On the other hand, the Act could apply to a franchisee that maintains a warehouse in Arkansas, even if the primary operations center is located elsewhere. In such cases, the analysis turns on

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21. Id.


23. Mary Kay v. Isbell, 999 S.W.2d 669, 671–72 (Ark. 1999) (holding that Act did not apply to relationship between the defendant cosmetics company and the plaintiff independent sales contractor because their contract explicitly provided that the plaintiff would not sell the defendant’s products from a fixed geographical location).
whether the parties contemplated the existence of a physical location within the state.\textsuperscript{24} Key factors in this analysis include the franchisor’s awareness of the franchisee’s connections to Arkansas and whether the franchisor expressly prohibited establishing a place of business in the parties’ contract.\textsuperscript{25}

In contrast to Arkansas, Delaware’s Franchise Security Act does not expressly require a franchisee to maintain a physical presence in the state.\textsuperscript{26} Nevertheless, the statute has been interpreted to include such a requirement. In \textit{33 Flavors of Greater Delaware Valley v. Bresler’s 33 Flavors}, the U.S. District Court for the District of Delaware held that the Delaware Act applied to the franchisee because it maintained a “place of business” within the state, based on the fact that it operated its business out of its Delaware home.\textsuperscript{27} Conversely, in \textit{KBQ v. E.I. du Pont de Nemours and Co.}, the franchisee was denied the benefit of the Delaware Act because it operated entirely out of state and its connection to Delaware was solely based on the fact that it was the location of the franchisor’s warranty center.\textsuperscript{28}

Finally, in states that narrowly construe the meaning of a “place of business,” the franchisee must maintain a particular type of location within the state in order for the statute to apply. For example, the Iowa Franchise Act expressly provides that a franchisee is deemed to operate in the state only when its “principal business office is physically located” in Iowa.\textsuperscript{29} Accordingly, a franchisee that alleges only that it maintains a “business practice” in the state will not receive the benefit of the Act.\textsuperscript{30}

Other states impose even more onerous restrictions. Notably, Nebraska and New Jersey both require that the franchisee possess a sales office in the state in order to receive the benefit of the statute. Similar to Arkansas, a franchisee must maintain a “fixed geographical location at which [it] displays for sale and sells the franchisor’s goods or offers for sale and sells the franchisor’s services” in order for their respective franchise acts to apply.\textsuperscript{31} But unlike Arkansas, these statutes expressly exclude offices, warehouses, storage facilities, residences, and vehicles from qualifying as “places

\textsuperscript{24} South Beach Beverage Co., Inc. v. Harris Brands, Inc., 138 S.W.3d 102, 106 (Ark. 2003).


\textsuperscript{26} See \textsc{Del. Code Ann. tit. 6, §§ 2551–2556}. In particular, section 2551 defines a franchise as “a contract or other arrangement governing the business relationship within this State between a franchised distributor and a franchisor. . . .” “Franchised distributor” is defined as “an individual, partnership, corporation, or unincorporated association with a place of business within the State.” \textsc{Del. Code Ann. tit. 6, §§ 2551(1)–(2)}.

\textsuperscript{27} 475 F. Supp. 2d 94, 99–100 (D. Mass. 1998) (holding that the franchisor’s warranty center could not constitute a place of business within Delaware for an otherwise out-of-state franchisee, even where the franchisee was assessed a proportionate fee for its operation).

\textsuperscript{28} IOWA \textsc{Code} § 523H.2.


\textsuperscript{30} N.J. \textsc{Stat. Ann.} § 56:10-3(f).
of business.”32 In addition, the franchise statutes in both Nebraska and New Jersey apply only to a franchise whose gross sales exceed $35,000 in the twelve months preceding a lawsuit and where at least twenty percent of the franchised business’s gross sales are derived from the franchise.33

Although these franchise regulations vary to some extent, their strict geographical restrictions reflect a common legislative intent to limit the reach of the statute to franchisees with business outlets located within their states.34 As a result, it is extremely unlikely that the franchise statutes in any of the narrow jurisdictions will apply to franchises without an established physical location in the state, even if the franchise agreement contains a choice of law provision selecting the state’s law, because “[w]hen a law contains geographical limitations on its application . . . courts will not apply it to parties falling outside those limitations, even if the parties stipulate that the law should apply.”35

B. The Middle-of-the-Road States

Most of the remaining franchising state statutes generally have a broader reach over the regulation of out-of-state franchises.36 Unlike the narrow territorial provisions discussed earlier, the state statutes discussed in this section will apply not only to franchisees with some type of brick-and-mortar location in the state, but also to non-resident franchisees or out-of-state franchises, as long as some meaningful element of the franchise relationship took place in the state.37


33. NEB. REV. STAT. § 87-403; N.J. STAT. ANN. § 56:10-4. These statutes are in essence a fractional franchise exemption, similar to the one included in the federal rule. The federal rule exempts “fractional franchises” from regulation as long as the prospective franchisees have existing industry experience and the sales from the fractional franchise will not exceed twenty percent of overall revenues for the business it supplements. 16 C.F.R. § 436.8.


35. Taylor v. 1-800-GOT-JUNK? LLC, 387 F. App’x 727, 729 (9th Cir. 2010). The rule stated in Taylor is consistent with a long line of cases. See Gravquik A/S v. Trimble Navigation Int’l, Ltd., 323 F.3d 1219, 1223 (9th Cir. 2003); Peugeot Motors of Am., Inc. v. E. Auto Distrib., Inc., 892 F.2d 355, 358 (4th Cir. 1989); Bimel-Walroth Co. v. Raytheon Co., 796 F.2d 840, 842–43 (6th Cir. 1986); Baldwin Co. v. Tri-Clover, Inc., 606 N.W.2d 145, 153 (Wis. 2000).

36. Florida and New York are the two exceptions. Courts have interpreted the franchise statutes of these two states, although very similar in language to the statutes of the states in this section, to have an extraordinarily, and likely unconstitutionally, broad territorial application. These statutes and their corresponding case law will be discussed in detail in the next section.

Generally, these middle-of-the-road states enacted their franchise laws within the first decade of the era of true franchise regulation. The territorial provisions of the moderate statutes are all very similar and, in some cases identical, in language. Typically, each statute’s territorial provision requires that the offer or sale of a franchise be “in this state,” a phrase that is defined as including situations where (1) the offer originated from within the state or (2) the offer was directed to and accepted within the state. Many of the moderate statutes discussed in this section also apply when the franchisee is a resident or the franchise is to be operated within the state. And critically, all moderate territorial provisions explicitly exempt offers or sales included as advertisements (1) in newspapers or publications that circulate largely outside of the state or (2) on radio or television programming originating outside the state.

The following subsections address the interpretative trends in states with middle-of-the-road statutes. It is clear from the judicial interpretation of the following statutes that the main concern prompting their enactment was the elimination of fraud actually occurring within each state’s borders and the protection of their own residents both in-state and abroad.

1. California

In California, the offer and sale of franchises is governed by the California Franchise Investment Law (CFIL), while the franchise relationship post-sale is governed by the California Franchise Relations Act (CFRA). California was the first state to enact statutes regulating the franchise industry in 1970, which comes as no surprise, because California was the epicenter of the franchising boom in the 1960s. By the end of the 1960s, California had more franchises than any other state, with almost ten percent of the 600,000 franchises that existed in the United States at that time. In enacting the CFIL, California clearly outlined the harm it equated with unregulated franchising:

The Legislature hereby finds and declares that the widespread sale of franchises is a relatively new form of business which has created numerous problems both from an investment and a business point of view in the State of California. Prior to the enactment of this division, the sale of franchises was regulated only to the limited extent to which the Corporate Securities Law of 1968 applied to those transac-

38. See statutes cited, supra note 37.
39. See statutes cited, supra note 37.
40. CAL. CORP. CODE § 31013; R.I. GEN. LAWS § 19-28.1-4; OR. REV. STAT. § 650.015; MICH. COMP. LAWS § 445.1507a; N.D. CENT. CODE § 51-19-02(14)(b); WASH. REV. CODE § 19.100.020; WIS. STAT. § 553.21, 815; 815 ILL. COMP. STAT. 705/3(20); S.D. CODIFIED LAWS § 37-5B-2; MD. CODE ANN., BUS. REG. § 14-203(a). This limitation makes sense from a constitutional perspective. Restrictions or regulation on the content of advertising that takes place wholly outside a state’s geographical boundaries poses significant potential constitutional problems because it may be considered an impingement on the franchisor’s freedom of speech, as well as regulation of interstate commerce.
41. Killion, supra note 2, at 19.
42. Id.
California franchisees have suffered substantial losses where the franchisor or its representative has not provided full and complete information regarding the franchisor-franchisee relationship, the details of the contract between franchisor and franchisee, and the prior business experience of the franchisor.\textsuperscript{43}

The California legislature also made no secret that one of the specific purposes of the CFIL was to “provide each prospective franchisee with the information necessary to make an intelligent decision regarding franchises being offered.”\textsuperscript{44} For these reasons, the CFIL applies only to the offer or sale of franchises made in the state of California.\textsuperscript{45} For the purposes of determining when offers or sales occur “in the state,” there are two relevant provisions of the CFIL: Sections 31013 and 31105. Section 31013 specifically limits the jurisdiction of the CFIL as follows:

(a) An offer or sale of a franchise is made in this state when an offer to sell is made in this state, or an offer to buy is accepted in this state, or, if the franchisee is domiciled in this state, the franchised business is or will be operated in this state.

(b) An offer to sell is made in this state when the offer either originates from this state or is directed by the offeror to this state and received at the place to which it is directed. An offer to sell is accepted in this state when acceptance is communicated to the offeror in this state; and acceptance is communicated to the offeror in this state when the offeree directs it to the offeror in this state reasonably believing the offeror to be in this state and it is received at the place to which it is directed.

(c) An offer to sell is not made in this state merely because (1) the publisher circulates or there is circulated on his behalf in this state any bona fide newspaper or other publication of general, regular, and paid circulation which has had more than two-thirds of its circulation outside this state during the past 12 months, or (2) a radio or television program originating outside this state is received in this state.\textsuperscript{46}

The CFIL also contains an exemption at Section 31105, however, which excludes application of the CFIL if the offer, sale, or transfer is directed to a non-resident and the franchise will not operate any customer-serving locations within the state.\textsuperscript{47} Although the exemption is titled “Operations Physically Located Outside of State,” the language of the statute is actually more complicated. It does not, as the title suggests, exempt all franchises that operate solely outside of California. Instead, by the plain language of the statute, if the franchise is offered or sold to a California resident, even if the franchise operates entirely outside of California’s borders, the CFIL should still apply. Similarly, if a franchise is sold to a non-resident that intends to operate it within California, the CFIL will apply.

\textsuperscript{43} \textit{Cal. Corp. Code} § 31001 (emphasis added).
\textsuperscript{44} Killion, \textit{supra} note 2, at 19.
\textsuperscript{45} \textit{Cal. Corp. Code} § 31013.
\textsuperscript{46} \textit{Cal. Corp. Code} § 31013.
\textsuperscript{47} \textit{Cal. Corp. Code} § 31105.
Federal courts explored the bounds of the CFIL in connection with out-of-state franchisees in both *Stocco v. Gemological Institute of America, Inc.* and *Dollar Systems, Inc. v. Avcar Leasing Systems, Inc.* In *Dollar Systems*, a decision issued in 1989, the court found that the CFIL applied to a non-resident franchisor that operated entirely outside of California. Specifically, the franchisee was a Virginia corporation that operated in Maryland, Virginia, and Washington D.C., and was present within the state of California only at the time the franchise agreement was negotiated, executed, and paid for, but never had any other contact with the state. The court nonetheless found that the CFIL applied because the negotiation and execution of the document within California’s borders brought the franchise agreement and relationship within California’s jurisdiction.

In reaction to the *Dollar Systems* decision, in 1996, the California legislature enacted Section 31105 and codified by statute that the CFIL did not apply to out-of-state franchisees. Thereafter, in *Stocco*, an Italian franchisee, GIA Italy, sued its California franchisor, GIA, for alleged violations of the CFIL. GIA was a resident of Italy and operated solely in Italy, although it had Italian students who worked in and visited California while earning gemologist degrees from GIA Italy. As a result, the court determined that Chapter 2 of the CFIL did not apply to the franchise agreement between GIA and GIA Italy pursuant to Section 31105. The court therefore dismissed the suit—the opposite result than the *Dollar Systems* case. The adoption of the revised statute in 1996 indicates a clear intent to undermine decisions like *Dollar Systems* and limit the applicability of the CFIL to California-owned or operated franchisees.

CFRA is even more limited in reach and is similar to narrow state statutes. The provisions of CFRA apply only to franchisees that are domiciled in the state and franchise businesses that are or have been operating within California. Like the CFIL, CFRA was enacted to “protect California franchisees, typically small business owners and entrepreneurs, from abuses by franchisors” but specifically with regard to “nonrenewal and termination of franchises.” The narrowed scope suggests recognition on the part of the California legislature that the requirements and obligations under the CFRA are more onerous than those of the CFIL. Nonetheless, the legislature was so concerned that such protections apply to all Californian franchises or franchisees that it also enacted an anti-waiver provision declaring that “[a]ny

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48. 890 F.2d 165 (9th Cir. 1989).
49. Id. at 171.
50. Id. (quoting CAL. BUS. & PROF. CODE § 20010 (1981)).
51. 975 F. Supp. 2d 1170 (9th Cir. 2013).
52. Id. at 1183.
condition, stipulation or provision to bind any person to waive compliance with any provision of this law is contrary to public policy and void.”

In an unpublished decision, the Ninth Circuit addressed the application of the statute in the context of a choice of law provision. In that case, the plaintiff, a nonresident of the state, brought suit after the defendant terminated the plaintiff’s distribution agreement. The plaintiff sought to invoke the protections of CFRA, but the court rejected this argument, holding that the Act’s limitations “apply in the instant case and bar [the plaintiff] from seeking relief under the Franchise Act.” In so holding, the court noted that CFRA’s domicile requirement was “an express geographic limitation on the applicability of the Franchise Act,” and therefore, the court was “bound by the limitations that a state legislature places on the scope of its laws.”

2. Rhode Island, Oregon, and North Dakota

The franchise statutes in Rhode Island, Oregon, and North Dakota all contain nearly identical territorial restrictions to those of the CFIL. The only significant difference is that none of these jurisdictions has the same explicit exemption for non-resident purchasers. Rhode Island does have a separate out-of-state exemption from registration requirements that applies if:

1. The franchise is offered or sold to a non-resident of Rhode Island;
2. The franchise business will not be operated wholly or partly in Rhode Island;
3. The offer or sale does not violate federal law or the law of the foreign jurisdiction; and
4. The offeree is not actually present in Rhode Island during any offer or sale.

It is likely that these statutes would be interpreted consistently with California’s statute, except that non-residents may be able to claim that the statutes apply in the absence of the explicit California exemption.

3. Michigan

The Michigan Franchise Investment Law (MFIL) appears to have a drafting mistake. Unlike California or the other middle-of-the-road states, there is no provision in the MFIL that limits the application of the statute to sales

57. Id.
58. Id.
59. Id. at *3.
60. Id.
61. Or, more accurately, The State of Rhode Island and Providence Plantations.
64. Unless, in the case of Rhode Island, the separate statutory exemption applies.
(or offers to sell) franchises “in this state.”65 To the contrary, the statute broadly states on its face that it applies to “all written or oral arrangements between a franchisor and a franchisee in connection with the offer or sale of a franchise. . . .”66 Yet despite not being limited to conduct “in this state,” the statute goes on to define when a sale or offer to sell occurs “in this state” in the same manner as the CFIL.67

It is unclear why these provisions define the circumstances under which an offer or sale is made “in this state” when the phrase “in this state” does not otherwise appear in the statute. The only rational explanation is that the omission of the phrase “in this state” was unintended. The accidental nature of the omission is supported by the fact that Michigan courts have applied the statute as though the phrase “in this state” is present. In Hacienda Mexican Restaurants of Kalamazoo Corp. v. Hacienda Franchise Group, Inc., the court held that the MFIL did not apply to a franchise agreement negotiated in Indiana between an Indiana franchisor and an Indiana franchisee, even though the franchise was to be operated in Michigan.68

4. Washington State

Washington was the second state to enact franchise regulation. Washington was hot on California’s heels as a result of local outrage from an unfortunate incident in which an out-of-state company fraudulently induced Washington residents to purchase worthless business opportunities.69 The company’s principals were ultimately indicted for fraud after they failed to deliver any vending machines to the franchises, but the damage was already done.70 The legislature concluded that an inherent power imbalance plagued franchise relationships due to the inability of inexperienced franchisees to access the information they needed to make reasonable choices.71 Washington

66. Id. This purportedly includes, but is not limited to, “the franchise offering, the franchise agreement, sales of goods or services, leases and mortgages of real or personal property, promises to pay, security interests, pledges, insurance, advertising, construction or installation contracts, servicing contracts, and all other arrangements in which the franchisor or subfranchisor has an interest.” Id.
68. 195 Mich. App. 35, 40 (1992). The court further noted that the Michigan attorney general, who investigated the parties’ activities in Michigan, agreed with the court’s analysis and recognized that the MFIL did not apply to a franchise to be operated in Michigan by an Indiana franchisee.
69. See James Fletcher, Franchise Investment Protection Act 14–15 (1971) (unpublished thesis, on file with University of Washington Gallagher Law Library). Although these business opportunities were the driving force behind Washington’s decision to adopt franchise regulation, the schemes do not even meet the definition of a franchise that the legislature ultimately adopted because they involved the sale or lease of equipment to allow a buyer to start a business. These schemes would therefore fall instead under the Business Opportunity Fraud Act. See generally Wash. Rev. Code § 19.110 (2008).
70. Fletcher, supra note 69, at 3.
71. Id. at 12–13; see also Donald S. Chisum, State Regulation of Franchising: The Washington Experience, 48 Wash. L. Rev. 291, 297–98 at n.1 (1973) (“Franchisors have used [their unequal bargaining] power to terminate franchises arbitrarily, to coerce franchisees under threat of termi-
therefore enacted the Franchise Investment Protection Act (FIPA) in an effort to curb the perceived imbalance. Rather than reinvent the wheel, when the Washington legislature enacted FIPA in 1972, the bulk of the statute was lifted almost directly from the CFIL, including the jurisdictional limiting phrase “in this state.” Specifically, FIPA’s registration and anti-fraud provisions limit their applicability to conduct occurring “in this state.”

Unlike the CFIL, however, when FIPA was originally enacted, the legislature omitted a definition of what constituted conduct occurring “in this state.” In a comprehensive article written one year after the statute was adopted, FIPA’s most frequently cited commentator, Professor Donald Chisum, noted this glaring omission, and recommended that FIPA be amended to conform to the CFIL, which Chisum noted “contains an adequate definition of the key phrase ‘in this state’ which carefully spells out the territorial coverage of the law . . . .” Despite Professor Chisum’s commentary, the legislature made no effort to update the language in the statute for nearly twenty years. That changed in the late 1980s, however, when two national organizations began work on proposed uniform franchising acts. Both proposed uniform acts included definitions for the phrase “in this state” that were substantially similar to California’s statute. In response to these events, the Washington legislature amended FIPA in 1991 to include a definition for the phrase “in this state” that is substantially similar to California law. Under the amended definition, FIPA applies to franchise sales or operations, and to force franchisees to purchase supplies from the franchisor or approved suppliers at unreasonable prices, to carry excessive inventories, to operate long, unprofitable hours, and to employ other unprofitable practices.

72. See WASH. REV. CODE § 19.100.020(2) (making it unlawful for a franchisor to sell or offer to sell an unregistered franchise “in this state”); see also WASH. REV. CODE § 19.100.170 (making it unlawful for any person to commit fraud or misrepresentation in connection with the sale of a franchise “in this state”).

73. Franchise Investment Protection Act, ch. 252, § 2 1971, Wash. Sess. Laws, 1st Ex. Sess. This is exactly the reverse of what happened in Michigan, which has a definition for “in this state,” but which failed to include a provision limiting the MFIL’s applicability to transactions and parties located “in this state.”

74. Chisum, supra note 71, at 337–38 (emphasis added).

75. UNIF. FRANCHISE & BUS. OPPORTUNITIES ACT (1987); MODEL FRANCHISE INV. ACT (1990).


77. The WSBA Committee spent three years reviewing the two uniform acts and the federal franchise rules before submitting a draft of proposed amendments to FIPA to the legislature in 1990. See An Act Relating to Franchise Investment Protection: Hearing on SB 5256–S Before the H. Comm. on Commerce & Labor, 1991 Leg., 52nd Sess. (Wash. 1991) (statement of C. Kent Carlson, Chairman of the Washington State Bar Association Franchise Act Revision Committee). When the legislature failed to report a bill to the governor before the close of the session, the WSBA Committee spent another year making revisions to the proposed amendments and returned during the 1991 session with a final proposed bill. Id. The drafters of the bill gave significant weight to the terms of the proposed uniform acts. Id. For a complete discussion of the procedural background of the amendment process, see Doug C. Berry, David M. Byers & Daniel J. Oates, State Regulation of Franchising: The Washington Experience Revisited, 32 SEATTLE U. L. REV. 811, 826 (2009).

78. Compare WASH. REV. CODE § 19.100.020(2), (3) with CAL. CORP. CODE § 31013. The definitions are not identical. In some respects FIPA is broader than the CFIL, and in some respects
fers to sell a franchise: 79 (1) directed into, and received in, Washington; (2) originating in Washington that violate the law of the state into which they are directed; (3) directed to Washington residents; or (4) relating to businesses to be located or operated in Washington. 80 To date, two promi-

it is narrower. The legislature narrowed the scope from the CFIL, such that FIPA only applies to offers that originate in Washington if the offer violates the franchise or business opportunity laws of the state into which it was directed. This seems more constitutionally permissible than California’s statute, which broadly includes any offer that originates in the state, without regard to the effect it has outside the state. At the same time, FIPA is broader than the CFIL in that it applies to offers that are made to Washington residents or offers that are made for franchises to be operated in Washington. Under the CFIL, the statute applies only if both conditions (residency and operation in the state) are satisfied.

79. Specifically, the statute provides in relevant part, as follows:

(2) For the purpose of this section, an offer to sell a franchise is made in this state when:
   (a) The offer is directed by the offeror into this state from within or outside this state and is received where it is directed, (b) the offer originates from this state and violates the franchise or business opportunity law of the state or foreign jurisdiction into which it is directed, (c) the prospective franchisee is a resident of this state, or (d) the franchise business that is the subject of the offer is to be located or operated, wholly or partly, in this state.

(3) For the purpose of this section, a sale of any franchise is made in this state when: (a) An offer to sell is accepted in this state, (b) an offer originating from this state is accepted and violates the franchise or business opportunity law of the state or foreign jurisdiction in which it is accepted, (c) the purchaser of the franchise is a resident of this state, or (d) the franchise business that is the subject of the sale is to be located or operated, wholly or partly, in this state.

(4) For the purpose of this section, an offer to sell is not made in this state solely because the offer appears: (a) In a newspaper or other publication of general and regular circulation if the publication has had more than two-thirds of its circulation outside this state during the twelve months before the offer is published, or (b) in a broadcast or transmission originating outside this state.

WASH. REV. CODE § 19.100.020.

80. WASH. REV. CODE §§ 19.100.020(2)–(3). As previously noted, WASH. REV. CODE § 19.100.020 is the section of the statute that applies to a franchisor’s failure to register a franchise. The language of this section specifically defines the phrase “in this state” “for purposes of this section.” Some have argued, based on a superficial reading of the provision, that the definition of “in this state” is limited to claims for failure to register and does not define the phrase “in this state” for purposes of anti-fraud claims under WASH. REV. CODE § 19.100.170. This argument is without merit, however, for a variety of reasons. First, it would mean that the phrase “in this state” means two different things in the same statute, which is a nonsensical result. Henry Indus., Inc. v. Dep’t of Labor & Indus., 381 P.3d 172, 185 (Wash. Ct. App. 2016) (“We must also avoid absurd results when interpreting statutes.”). Second, it is belied by the legislative history of the amendments, which were specifically adopted with the intention of limiting the jurisdictional reach of the statute, consistent with the proposed uniform acts. See, e.g., Franchise Investment Protection Act, ch. 252, § 2 1971 Wash. Sess. Laws, 1st Ex. Sess.; An Act Relating to Franchise Investment Protection: Hearing on SB 5256-S Before the H. Comm. on Commerce & Labor, 1991 Leg., 52nd Sess. (Wash. 1991) (statement of C. Kent Carlson, Chairman of the Washington State Bar Association Franchise Act Revision Committee). Third, other states have similarly adopted jurisdictional limiting language, and courts have applied it as it was intended (consistent with other states), even in light of poor draftsmanship. See, e.g., Hacienda Mexican Rests. of Kalamazoo Corp. v. Hacienda Franchise Grp., Inc., 195 Mich. App. 35, 40 (1992) (limiting claims under MFIL to those occurring “in this state,” a defined term under the Michigan statute, even though the statute does not limit its applicability to actions occurring “in this state”). And finally, it would mean that the phrase “in this state” in WASH. REV. CODE § 19.100.170 would need to be read for its plain meaning. The plain meaning of the phrase “in this state” is precisely that: the actual conduct giving rise to the fraud would need to occur in Washington, i.e., the fraudulent statement must be made and received. This is a much narrower definition than the
nent cases interpret Washington’s revised definition: Taylor v. 1-800-GOT JUNK?, LLC and Red Lion Hotels Franchising Inc. v. MAK LLC.

In Taylor, an Oregon-based franchisee brought pre-sale anti-fraud claims against a Vancouver, Canada-based franchisor under FIPA. The court held that although the parties had expressly elected to apply Washington law, FIPA’s express geographical limitations precluded application of the Act. Because both of the parties were located outside of Washington (in Oregon and Canada, respectively) and no negotiations or executions of the franchise agreement had taken place in Washington, nothing occurred “in this state” as that term is defined under WASH. REV. CODE § 19.100.020(2)–(3), and FIPA did not apply.

The Red Lion case involved a different provision in the FIPA statute. Specifically, in that case, a franchisor with its principal place of business located in Washington terminated the franchise agreement and sued a California-based franchisee for breach of contract when the franchisee failed to make repairs and upgrades to its hotel as required by the franchise agreement. The franchisee responded by bringing a counterclaim against the franchisor under the Washington Consumer Protection Act (CPA), alleging that the franchisor had wrongfully terminated the franchise agreement in violation of FIPA’s post-sale relationship provisions. Unlike FIPA’s registration and anti-fraud provisions, the post-sale relationship provision (commonly referred to as the “franchisee bill of rights”) does not contain the qualifying jurisdictional lan-

broader language adopted by the legislature in WASH. REV. CODE § 19.100.020. Because FIPA was intended to be interpreted broadly for the protection of franchisees, the only logical interpretation of the phrase “in this state” under WASH. REV. CODE § 19.100.170, is the same as the interpretation expressly given under WASH. REV. CODE § 19.100.020. For this reason, the Ninth Circuit has twice held that it was appropriate for the court in Taylor to apply the language in WASH. REV. CODE § 19.100.020 when interpreting the phrase “in this state” in WASH. REV. CODE § 19.100.170. Taylor v. 1-800-Got-Junk?, LLC, 387 F. App’x 727, 729 (9th Cir. 2010); Red Lion Hotels Franchising Inc. v. MAK LLC, 663 F.3d 1080 (9th Cir. 2011) (“[I]t is clear that the Taylor court reached the right result on the facts of the case. Plaintiffs’ underlying FIPA claim [in Taylor] was for fraud in the sale of the franchise, and FIPA’s fraud provision contains an explicit territorial limitation.”).

82. Id. at 1052 (“[A] specific territorial limitation on the application of a state law [FIPA] must be given effect even where the parties contractually agree that the law of that state applies.”).
83. Id. at 1052–54; see also Taylor, 387 F. App’x at 729 (affirming the district court opinion and noting that “FIPA applies only to conduct occurring in Washington.”). Id. The court also maintained that it did not matter that the franchise agreement selected Washington law for the choice of law provision because FIPA has express territorial limitations excluding out-of-state conduct from its application. Id. This is consistent with the Restatement (Second) of Conflict of Laws, which expressly provides that a territorial restriction is not a choice of law provision. See RESTATEMENT (SECOND) OF CONFLICT OF LAWS § 80, cmt. c (1989) (stating that a court should disregard a choice of law provision if the law of the chosen state would not apply to the parties or the transaction on its face).
84. 663 F.3d 1080 (9th Cir. 2011).
85. Id.
87. Red Lion, 663 F.3d at 1086.
guage limiting claims to conduct occurring “in this state.” Noting this difference from the earlier Taylor case, the Ninth Circuit concluded that the legislature may not have wanted to limit claims under the post-sale relationship provision to the same extent as the anti-fraud and registration provisions. Moreover, unlike in Taylor, the franchisor in Red Lion had its principal place of business located in Washington, and all of the interactions between the franchisor and franchisee took place between Washington and California. As a result, the court concluded that there were factual questions that precluded summary judgment on the CPA claim, particularly given that the CPA contains its own jurisdictional limiting language, which the district court had never addressed. The court therefore remanded the case to the district court for the purposes of determining whether the CPA’s own territorial limitations applied under the circumstances. The court did note, however, that FIPA’s other sections contain express geographic limitations and that the Taylor case was rightly decided because FIPA’s anti-fraud provision contains a jurisdictional limitation. According to the court, FIPA’s territorial limitations simply did not apply to preclude a claim under the statute’s post-sale relationship sections.

5. Wisconsin

Wisconsin has enacted both a franchise registration law and a franchise relationship law, but the relationship law, officially titled the Wisconsin Fair Dealership Law, actually applies to dealerships, not franchises. The Wisconsin Franchise Investment Law (WFIL) governs franchise disclosures and registration. It is subject to the following territorial limitations:

(1) The provisions of this chapter concerning sales and offers to sell apply when a sale is made in this state or when an offer to sell is made or accepted in this state, except that s. 553.21 does not apply to an offer to sell that is not directed to, or received by, the offeree in this state.

89. Red Lion, 663 F.3d at 1090. In reaching this conclusion, the court completely ignored the extensive legislative history of the statute. Instead, the court invented a hypothetical rationale that the legislature might have intended that was wholly unsupported by the record. Id. at 1091 (“[T]he Washington legislature might have wanted to apply FIPA’s bill of rights to all franchises and franchisees of Washington franchisors . . .”) (emphasis added). In light of the fact that there is no actual legislative history to support this supposition, and, in fact, the evidence was to the contrary, the decision in the Red Lion case is suspect, if not simply incorrect.
90. Id. at 1082.
91. Id. at 1091.
92. Id. (“The territorial reach of the CPA is thus an open question. We agree with Red Lion that the CPA provides the remedy for violation of FIPA’s bill of rights. We remand to the district court to consider the merits of Karimi’s FIPA counterclaim under FIPA’s bill of rights and to determine whether Karimi is entitled to a remedy under the CPA.”).
93. Id. at 1090 (“[T]he district court in Taylor was clearly correct in concluding that the Washington legislature did not intend FIPA to apply [to an anti-fraud claim under Wash. Rev. Code § 19.100.170] . . .”).
94. Id. at 1091.
For the purpose of this section, an offer to sell is made in this state if the offer either originates in this state or is directed by the offeror to this state and received by the offeree in this state.

For the purpose of this section, an offer to sell is accepted in this state if acceptance is communicated to the offeror from this state.

An offer to sell is not made in this state if the publisher circulates or there is circulated on the publisher’s behalf in this state any bona fide newspaper or other publication of general, regular and paid circulation that is not published in this state or if a radio or television program that originates outside this state is received in this state.

This provision was interpreted in Maryland Staffing Services, Inc. v. Manpower, Inc., a case in which a Maryland franchisee, Maryland Staffing Services, Inc. sued its Wisconsin-based franchisor, Manpower, Inc. for alleged violations of the WFIL. Manpower moved to dismiss the claim on the basis that the WFIL did not apply to an out-of-state franchisee like Maryland Staffing. The court interpreted Section 553.59 to require that “(1) either the offer to sell or purchase the franchise (a) originates in Wisconsin or (b) is directed to Wisconsin and (2) the offer to sell or purchase is received in Wisconsin.” Because it found no facts in the record to support a finding that “the offer was received by Maryland Staffing in Wisconsin,” the court concluded that Maryland Staffing had failed to state a claim.

The court’s interpretation of Section 553.59(1) in Maryland Staffing seems to ignore the actual language of the statute, which provides that the WFIL applies when, inter alia, “an offer to sell is made or accepted in this state.” In Cousin Subs System Inc. v. Better Subs Development Inc., a later court seemed to recognize this problem, holding that the plain meaning of the statute allows for application of the WFIL where “(1) an offer originates in Wisconsin; or (2) an offer is directed by the offeror to Wisconsin and the offer is received by the offeree in Wisconsin.” Although the court quoted Maryland Staffing, it made no apparent effort to reconcile its own ruling with the prior case. Perhaps for that reason, the Cousin Subs court never published its decision.

Although the Maryland Staffing decision is inconsistent with the plain language of the WFIL, it is consistent with the legislative history of the statute, which expressed a clear intent to protect only Wisconsin franchisees. Al-

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96. Wis. Stat. § 553.59 (2017); Section 553.21 prohibits selling of a franchise in Wisconsin unless the franchise has been registered pursuant to the chapter or is otherwise exempted.
98. Id. at 1506.
99. Id.
100. Id.
103. Id.
104. Maryland Staffing Servs., Inc., 936 F. Supp. at 1506 (“This reading is supported by the legislative history of the WFIL, which makes it clear that the legislature was concerned with
though the court did not state it explicitly, the decision suggested that the court was interested only in the protection of Wisconsin-based franchisees, not those of other states.\textsuperscript{105} In other words, the WFIL was not intended to protect out-of-state franchisees, even from predatory Wisconsin-based franchisors.

6. Minnesota

The Minnesota Franchise Act (MFA) is very similar to the CFIL: it applies when an offer or sale is made or accepted in the state or when the franchise is to be operated in Minnesota.\textsuperscript{106} The MFA also creates a specific exemption to the application of the statute for, among other things:

the offer or sale of a franchise to a resident of a foreign state, territory, or country who is neither domiciled in this state nor actually present in this state, if the franchise business is not to be operated wholly or partly in this state, and if the sale of this franchise is not in violation of any law of the foreign state, territory, or county concerned.\textsuperscript{107}

The language of the MFA differs from others in a number of interesting ways. First, in defining when an offer is made or accepted “in this state,” the statute specifically notes that neither party actually has to be present within the state for an offer to originate in the state or be received in the state.\textsuperscript{108} This language is a dramatic departure from the language of other state statutes, and Section 80C.19 does nothing to explain how an offer could originate from or be received in a state by parties that are not present in the state. Second, although Section 80C.19 has the standard exemption for offers made in publications or on radio or television outside the state, the exemption is not based on the timing or proportion of the circulation that occurs outside the state; rather, Section 80C.19 exempts publications only if they are “not published in this state.”\textsuperscript{109} The term “published” is not defined in this context, but it is possible that even a publication that was entirely circulated within Minnesota might be exempt as long as it was published in another state.

Several cases have explored the territorial reach of the MFA, and where the franchisee is a Minnesota resident, generally any amount of contact protecting “Wisconsin franchisees,” which the state legislature believed to have suffered substantial losses as a result of unscrupulous franchisors.”\textsuperscript{105}

\textsuperscript{105.} Id.

\textsuperscript{106.} Minn. Stat. § 80C.19 (2017).

\textsuperscript{107.} Minn. Stat. § 80C.03(h). This language is virtually identical to language employed by California regulators before the adoption of Cal. Corp. Code § 31105. See Cal. Code Regs. tit. 10, § 310.100.1 (1989). The California regulation was repealed in 2002, presumably because it was obsolete after the enactment of Section 31105. Minnesota continues to use this alternative formulation.

\textsuperscript{108.} Minn. Stat. § 80C.19(2) (“[A]n offer to sell or purchase is made in this state, whether or not either party is then present in this state. . . .”).

\textsuperscript{109.} Minn. Stat. § 80C.19(4).
while the franchisee is in Minnesota constitutes an offer in the state.\textsuperscript{110} In *Martin Investors, Inc. v. Vander Bie*, the court determined that the franchisor had made offers in Minnesota under Section 80C.19 in several ways: (1) it published advertisements for consultants in two Minnesota newspapers; (2) it discussed the arrangement with the franchisee on a phone call while the franchisee was in Minnesota; and (3) it mailed a sample agreement to the franchisee in Minnesota.\textsuperscript{111} According to the court, these three activities\textsuperscript{112} constituted “precisely the kind of activity that our act was designed to regulate. . . .”\textsuperscript{113} The MFA was drafted broadly, and the Minnesota courts are therefore likely to interpret it broadly as well.

7. Illinois

Franchises in Illinois are governed by the Illinois Franchise Disclosure Act (IFDA). The IFDA regulates registration and disclosure of franchises; pre-sale misrepresentations and fraud; and post-sale relationship issues, such as discrimination, termination, and non-renewal of the franchise relationship.\textsuperscript{114} Like California, the legislature of Illinois found that the sale of franchises was widespread in Illinois and had caused residents to suffer substantial losses as a result of incomplete information about the franchise offerings.\textsuperscript{115} The stated intent of the IFDA was therefore to “provide each prospective franchisee with the information necessary to make an intelligent decision regarding franchises being offered.”\textsuperscript{116}

Unlike California, or most other states, Illinois’ various franchise sections are subject to different territorial limitations. The territorial limits for the post-sale relationship provisions of the IFDA are the strictest. They apply only to franchised businesses physically located in the state.\textsuperscript{117} The registration/disclosure requirements apply only to franchise businesses that are (1) domiciled in the state or (2) operated in the state, as long as the franchise offer was made or accepted in the state.\textsuperscript{118} Section 705/3(20) delineates when an offer is made or accepted in the state for the purposes of the registration and disclosure section of the statute:

\begin{quote}

111. *Martin Investors*, 269 N.W.2d at 873.

112. Particularly the mailing of the sample agreement.

113. *Martin Investors*, 269 N.W.2d at 873.

114. 815 ILL. COMP. STAT. 705/3.

115. 815 ILL. COMP. STAT. 705/2(1).

116. 815 ILL. COMP. STAT. 705/2(1).

117. 815 ILL. COMP. STAT. 705/18 (“It shall be an unfair franchise practice and a violation of this Act for any franchisor to unreasonably and materially discriminate between franchisees operating a franchised business located in this State . . .”); 815 ILL. COMP. STAT. 705/19 (“It shall be a violation of this Act for a franchisor to terminate a franchise of a franchised business located in this State . . .”); 815 ILL. COMP. STAT. 705/20 (“It shall be a violation of this Act for a franchisor to refuse to renew a franchise of a franchised business located in this State . . .”).

118. 815 ILL. COMP. STAT. 705/2(2). The IFDA also expressly sought to protect both franchisee and franchisor by providing a greater understanding of the relationship between the two.
(a) An offer to sell a franchise is made in this State when the offer either originates from this State or is directed by the offeror to this State and received at the place to which it is directed. An offer to sell is accepted in this State when acceptance is communicated to the offeror in this State; and acceptance is communicated to the offeror in this State when the offeree directs it to the offeror in this State reasonably believing the offeror to be in this State and it is received at the place to which it is directed.

(b) An offer to sell a franchise is not made in this State merely because the franchisor circulates or there is circulated in this State an advertisement in (i) a bona fide newspaper or other publication of general, regular and paid circulation which has had more than 2/3 of its circulation outside this State during the past 12 months, or (ii) a radio or television program originating outside this State which is received in this State. 119

The anti-fraud provision of the statute has the broadest reach. It prohibits fraud, misrepresentations, or omissions in connection with the offer or sale of any franchise made in Illinois. 120 For this section, a sale is made in Illinois when “(i) an offer to sell or buy a franchise is made in this State and accepted within or outside of this State, or (ii) an offer to sell or buy a franchise is made outside of this State and accepted in this State, or (iii) the offeree is domiciled in this State, or (iv) the franchised business is or will be located in this State.”

Although there are no cases interpreting the IFDA’s scope as it applies to anti-fraud, or registration and disclosure, there is substantial case law addressing the reach of the statute in the post-sale relationship sections of the statute. For example, in McDonald’s Corp. v. C.B. Co., Inc., the court examined the then-existing case law in both Illinois and elsewhere regarding the applicability of the IFDA to the termination of franchise locations in Ohio where the franchise agreement had an Illinois choice of law provision. 121 The court noted that there was significant case law for both the proposition that state franchise laws should apply outside of state borders and that they should not. 122 However, the court sided with the weight of legal authority on the issue, finding that the IFDA does not apply to non-Illinois franchises. 123

In making its determination, the court explained that after the franchise legislation originally passed in 1973, the Illinois Supreme Court explicitly stated “it would not give extraterritorial effect to Illinois statutes unless

119. 815 ILL. COMP. STAT. 705/3(20) (2009).
120. 815 ILL. COMP. STAT. 705/6 (1988).
123. McDonald’s Corp., 13 F. Supp. 2d at 714.
the legislature expressly directed it to do so.” Accordingly, the court felt that the reach of the IFDA could not extend beyond Illinois borders, specifically where, as here, the legislature added language to the original statute in 1988 to limit its applicability to businesses located in the State of Illinois. In fact, the legislative history for the IFDA indicated that the statute was enacted because “the widespread sale of franchises . . . has created numerous problems in Illinois” and the legislature wanted to protect Illinois residents from situations where a franchisor “has not provided full and complete information regarding the franchisor-franchisee relationship, the details of the contract. . . , the prior business experience of the franchisor, and other factors relevant to the franchise offered for sale.”

The McDonald’s court recognized that its ruling, in reality if not on its face, directly contradicted prior case law. Specifically, in Infomax Office Systems, Inc. v. MBO Binder & Co. of America, the court rejected the proposition that the IFDA should not apply to an out-of-state franchisee if the parties agreed to apply Illinois law, but ultimately found the IFDA did not apply for other reasons. The McDonald’s court explained that because Infomax was decided based upon that court’s determination that applying the IFDA would give effect to the parties’ contract rather than Illinois law, Infomax would not require a different outcome under the McDonald’s set of facts. The court nonetheless elaborated that even if did, the Infomax decision was wrong; applying the IFDA to the franchisees in that case gave extraterritorial effect to the laws of Illinois against legislative intent. The proper way to give effect to the parties’ choice of law provision was to apply the IFDA as it was written, meaning that the parties would be excluded under its terms.

Similarly, In Cromeens, Holloman, Sibert, Inc., v. AB Volvo, the Seventh Circuit took the McDonald’s decision one step further. In that case, the plaintiffs were franchisee-dealers of Samsung products located in Texas, Maine, Montana, New York, and two Canadian provinces. After Samsung terminated their dealer agreements, the franchisees sued in Illinois, claiming that the substantive portions of the IFDA applied to prohibit termination of the franchise agreements because the choice of law provision stated that the contracts would be “construed and interpreted in accordance with the law of the State of Illinois.” But the IFDA, by its own terms, applied only to fran-
chises located within the State of Illinois. The plaintiffs argued that the territorial limitation did not apply, because under the Restatement of Conflict of Laws, a choice of law provision only incorporates the “local law” of the chosen state and excludes the chosen state’s choice of law rules. The court rejected that argument, noting that a statute’s territorial limitations are not choice of law rules. Instead, the court looked to the IDFA to see if it applied on its face, concluding:

The plain language of the Illinois law that the Samsung Dealers seek to apply excludes those same dealers from its coverage because they are located outside of Illinois. Nothing in the Restatement suggests a contrary result. The Restatement excludes from “local law” only the choice-of-law rules of the state, not any territorial limitations contained in the statute.

Despite the narrow application of the post-sale relationship provisions of the statute, a court is likely to adopt a broader interpretation of the pre-sale disclosure, anti-fraud, and registration provisions, consistent with other jurisdictions.

8. South Dakota

The South Dakota Franchise Investment Act (SDFIA) is purely a notice filing statute and very little case law has developed around it. Although stated in plainer language, the statute appears to be similar to the CFIL, in that it applies only to sales occurring “in this state,” which includes instances where the offer is made within the state, originates from within the state, or is directed into South Dakota from outside the state, and is received where it is directed. And like California, the statute applies if the franchisee is a resident or domiciliary of the state and the franchise is to be operated in the state. Section 37-5B-3 specifically exempts from the statute’s requirements offers that were made in newspapers that had more than two-thirds of their circulation outside the state for the past twelve months or for radio and television broadcasts originating outside of the state.

Like the CFIL, the SDFIA also has an exemption for out-of-state franchisees, albeit a narrower one than in California. Specifically, franchises are not subject to the statute’s requirements if the franchisee is not a resident of South Dakota, the franchise location will not be in South Dakota, and if the offer or sale does not constitute a violation of the laws of the state or foreign jurisdiction in which the offeree or purchaser is present and is not part of an unlawful attempt to evade the SDFIA.

135. Id.
136. Id.; see also Restatement (Second) of Conflict of Laws § 187(3) cmt. h (1989).
137. Cromeens, 349 F.3d at 385.
138. Id. at 386.
139. Previously known as the South Dakota Franchise Act.
140. S.D. Codified Laws § 37-5B-2.
141. S.D. Codified Laws § 37-5B-2.
142. S.D. Codified Laws § 37-5B-3.
143. S.D. Codified Laws § 37-5B-3.
Finally, the SDFIA appears to be the only state territorial restriction that has been updated to decree explicitly that an offer is not made in the state if it is made over the Internet or some other common electronic carrier, provided:

1. The internet offer indicates that the franchise is not being offered to residents of South Dakota;
2. The internet offer is not directed to any person in South Dakota by or on behalf of the franchisor or anyone acting with the franchisor’s knowledge; and
3. No franchise is sold in South Dakota by or on behalf of the franchisor until the offering has been filed by notice and the franchise disclosure document has been delivered to the purchaser prior to the sale and in compliance with this chapter.144

Presumably, if regulators in states other than South Dakota attempt to assert jurisdiction over a putative franchisor using Internet advertising, that assertion would be constitutionally overbroad in the same way that claims to nationwide television and print advertising would be. As such, adoption of similar exceptions for Internet advertising is probably warranted.

The only South Dakota case to touch on the issue of the SDFIA’s territorial reach was Pinnacle Pizza Co, Inc. v. Little Caesar Enterprises, Inc., which dealt with a forum selection clause in a franchise agreement.145 Because the franchisees operated franchise business locations in Sioux Falls, South Dakota, the court determined that the forum choice of Michigan violated the public policy underlying the SDFIA and therefore applied the SDFIA.146

9. Maryland

The Maryland Franchise Registration and Disclosure Law (MFRDL) was originally enacted in 1979 with language to the effect that its requirements applied only if “(1) the offeree is a Maryland resident; (2) the contemplated franchise will be or is operated in the state; (3) an offer to sell is made in the state; or (4) an offer to buy is accepted in the state.”147 Like Washington, the MFRDL’s jurisdiction included not only transactions that occurred within Maryland’s borders, but also transactions that occurred outside of it as long as they involved a Maryland resident. And also similar to Washington before it amended its statute, the MFRDL did not explain under what circumstances an offer would be considered to have been made or accept “in the state.”148 Maryland quickly corrected this ambiguity, passing an amendment in 1980 that clarified the circumstances under which an offer is deemed

144. S.D. CODIFIED LAWS § 37-5B-2.
145. 395 F. Supp. 2d 891 (D.S.D. 2005). Although this case dealt with the application of the state’s franchise law at that time, the statute was subsequently repealed.
146. Id.
148. Id. at 12.
made or accepted in Maryland.\(^{149}\) With the amendment, Maryland’s original
franchise statute was substantially similar to its current one, which mirrors
much of the language in the similar provisions of the CFIL, except that,
like Washington, the statute applies to state residents who purchase a fran-
chise, even if the franchise is to be operated outside of Maryland.\(^{150}\)

Like the CFIL, an offer to sell is made if it “(i) originates from the State;
or (ii) is directed by the offeror to the State and is received at the place to
which it is directed.”\(^{151}\) An offer is accepted in Maryland when “(i) the of-
feree directs acceptance to the offeror in the State reasonably believing the
offeror to be in the State; and (ii) the acceptance is received at the place to
which it is directed.”\(^{152}\) And similar to most other jurisdictions, an offer is
not deemed to have been made in Maryland if it is circulated in Maryland
in a publication that has two-thirds of its circulation outside of Maryland in
the prior twelve months or if it is an advertisement on the radio or television
that originated outside the state.\(^{153}\)

The jurisdictional provision of the MFRDL was tested in \textit{A Love of Food I,
LLC v. Maoz Vegetarian USA, Inc.} \textit{A Love of Food} involved a New York fran-
chisor, a Washington D.C.-based franchise, and a franchisee that was incor-
porated in Delaware with its principal place of business in Maryland.\(^{154}\)
Despite the geographic dissonance, the court determined that Maryland
franchise law applied to the franchise relationship between the parties.
The court reasoned that the franchisee was a Maryland resident because
its principal place of business was in Maryland and, where a resident signs
a franchise agreement, that state’s franchise act generally applies.\(^{155}\)

\begin{thebibliography}{1}
\bibitem{149} Id.
\bibitem{150} \textsc{Md. Code Bus. Reg.} \textsection 14-203(a).
\bibitem{151} \textsc{Md. Code Bus. Reg.} \textsection 14-203(b)(1).
\bibitem{152} \textsc{Md. Code Bus. Reg.} \textsection 14-203(b)(3)–(4).
\bibitem{153} \textsc{Md. Code Bus. Reg.} \textsection 14-203(b)(2).
\bibitem{154} \textit{A Love of Food I, LLC v. Maoz Vegetarian USA, Inc.}, 70 F. Supp. 3d 376, 388 (D.D.C.
2014).
\bibitem{155} Id. at 392. This creates a potential conflict of law problem. As set forth in detail later,
New York’s statute is interpreted very broadly. If the parties’ contract had contained a New
York choice of law provision, the franchisor could arguably have been required to comply
with \textit{both} New York and Maryland law, an absurd result. \textit{See} discussion \textit{infra} Part II.C.2. It is
likely that under this scenario (i.e., a franchisee that enters into a contract to open multiple fran-
chised outlets in multiple jurisdictions), the court would first need to evaluate which law could
apply to each franchised outlet. In many cases, only the law of one jurisdiction could possible
apply due to the territorial restrictions imposed by the statute. In instances where more than
one statute could theoretically apply (such as the Maryland/New York example above), the
court would likely evaluate which law is the most protective of the franchisee and then apply
that law. Accordingly, where a multi-unit franchisee is embroiled in a dispute with a franchisor,
the parties should carefully evaluate their preferred venue to try to determine which jurisdiction
is most likely to apply the law the filing party deems most favorable. Moreover, to avoid this
problem, franchisors should refrain from entering into broad contracts that allow franchisees
to operate multiple franchised outlets in different jurisdictions. Instead, franchisors should
seek to carve out franchise territories and agreements by jurisdiction to avoid potential applica-
tion of multiple franchise regulatory schemes. This may even include requiring a master fran-
chisee to create subsidiary businesses to own and operate the franchised businesses that are located
in the state in which the franchised business is intended to operate.
\end{thebibliography}
C. The Broad States

Of the territorial limitations in state franchise statutes, two stand apart as particularly broad in their application: Florida and New York. Florida’s statute is not, on its face, any broader than any of the other statutes, but it is so vague as to invite expansive interpretations. New York’s statute, conversely, contains a territorial provision similar to the middle of the road states, but the courts have construed it to be far broader. The reach of these statutes, as they have been interpreted, raises serious constitutional concerns addressed further in the next section.

1. Florida

The Florida Franchise Misrepresentation Act (FFMA) prevents any “person” from misrepresenting information relating to a franchise sale. For the purposes of the Act, a “person” is defined as an “individual, partnership, corporation, association, or other entity doing business in Florida.”156 No definition is given for what constitutes “doing business in Florida,” and there appears to be no legislative history interpreting the phrase. A number of courts have addressed the territorial limits of Florida’s statute anyway, with somewhat startling results.

In Burger King v. Austin, a franchisee alleged that Burger King violated the FFMA by intentionally misrepresenting pertinent facts related to the sale of a franchise.157 Burger King moved to dismiss the claim, asserting that the FFMA did not apply because the franchise was located out of state and the parties did not do business in Florida.158 The court denied Burger King’s motion and held that because the parties’ contract contained a Florida choice of law provision, the parties demonstrated their intent to be regarded as doing business in Florida.159 In essence, the court held that no contacts were actually needed with the state at all, as long as the parties agreed that Florida law should apply.

Similarly, in Burger King Corp. v. Holder, a franchisee brought an action against Burger King for violations of the FFMA in relation to the sale of franchises located in Kansas.160 Burger King again argued that the FFMA did not apply because the claim related to out-of-state franchises.161 The court denied its motion to dismiss because the franchisee alleged that Burger King did business in Florida and that some of the portions of the transaction occurred there.162 Accordingly, Burger King was considered a “person” under the Act “doing business in Florida.”163

158. Id.
159. Id.
161. Id.
162. Id.
163. Id.
Conversely, in *Lady of America Franchise Corp v. Malone*, the court interpreted the FFMA to apply only when both the franchisor and the franchisee did business in Florida. Despite this more restrictive interpretation, the court inexplicably held that the FFMA applied between a Florida franchisor and an out-of-state franchisee solely because of the Florida choice of law provision in the parties’ contract. According to the court, the addition of a Florida choice of law provision in the agreement was sufficient to satisfy the residency requirement limiting the FFMA’s applicability.

*Barnes v. Burger King Corp.*, however, breaks with this line of cases. In *Barnes*, the court granted the franchisor’s motion to dismiss and held that the franchisee lacked standing to assert a FFMA claim because it did not do business in Florida and its franchise was located out-of-state. The court granted the motion despite the fact that the parties’ contract contained a Florida choice of law provision. The court did not believe that an injustice would result against the franchisee because it possessed other legal remedies against the franchisor even without the benefit of the Act.

In light of the conflicting case law, and the vagueness of the statute, it is unclear what the true scope of the FFMA would be, if challenged on appeal.

2. New York

The legislative history of the New York Franchise Sales Act (NYFSA) provides unique insight into the development of the country’s most restrictive and far reaching franchise legislation. New York enacted the NYFSA in 1980, with an effective date of January 1, 1981. Its passage followed two years after the promulgation of the FTC Franchise Rule, although the NYFSA is far more onerous. A

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165. *Id*.
166. *Id*. There is ample case law in other jurisdictions standing for the proposition that a territorial limitation in a statute must be strictly construed and cannot be overridden by the contractual agreement of the parties. See Peugeot Motors of Am., Inc. v. E. Auto Distrib., Inc., 892 F.2d 355, 358 (4th Cir. 1990) (holding that New York Franchise Motor Vehicle Act did not apply to non-New York distributor despite New York choice of law); Highway Equip. Co. v. Caterpillar, Inc., 908 F.2d 60 (6th Cir. 1990) (holding that Illinois Franchise Dealer Act did not apply to Ohio-based franchisee despite Illinois choice of law); Cromeens, Holloman, Sibert, Inc., v. AB Volvo, 349 F.3d 376, 385 (7th Cir. 2003) (“The plain language of the Illinois law that the Samsung Dealers seek to apply excludes those same dealers from its coverage because they are located outside of Illinois.”); Taylor v. 1-800-GOT-JUNK? LLC, 632 F. Supp. 2d 1048 (W.D. Wash. 2009) (“[T]he relevant state law contains an “express geographic limitation as to its application,” and therefore, “courts will not apply it to parties falling outside those limitations, even if the parties stipulate that the law should apply.”); Fred Briggs Distrib., Inc. v. Cal. Cooler, Inc., No. 92-35016, 1993 WL 306157 (9th Cir. Aug. 11, 1993).
168. *Id*.
169. *Id*.
170. 4D N.Y. PRACTICE SERIES, COMMERCIAL LITIGATION IN NEW YORK STATE COURTS § 100:3 (4th ed.) (“The Act has been interpreted to have the widest geographical scope of any franchise regulation in the nation.”).
number of critics commented on this during the legislative process, arguing that the FTC Rule should be given time to take effect. Nonetheless, the legislature passed the NYFSA, seemingly on the strength of the New York Attorney General’s findings regarding franchise abuse.

On its face, the NYFSA applies only if any of the following is true: (1) an offer to sell is made in New York, (2) an offer to buy is accepted in New York, or (3) the franchisee is domiciled in New York, or the franchise will be operated in New York. This language makes it facially similar to Washington, albeit slightly narrower, because it does not contain a section on offers originating in New York. And New York defines what constitutes an “offer or sale” in the same way as California and other middle-of-the-road states.

The NYFSA territorial provision has been interpreted in a number of cases. In only one instance has the court held that a franchise regulation did not apply to a non-New York franchisee where the parties had agreed to apply New York law to the contract. In a number of others, the New York courts were not so restrained.

For example, in *Mon-Shore Management v. Family Media*, the franchisor argued that the NYFSA was unconstitutional as a violation of the Commerce Clause. In particular, the franchisor argued that the NYFSA was a burden on interstate commerce to the extent that it governed the offer and sale of franchises to out-of-state parties. The court rejected this argument on the basis that the NYFSA applies only to those parties or transactions that demonstrate a strong connection to New York; accordingly, it would not apply to commerce that takes place “wholly outside” of New York.

Similarly, in *A Love of Food I, LLC v. Maoz Vegetarian USA*, the court also held that the NYFSA applied to a transaction between the parties despite the fact that the franchisee and the franchise were located out of state. It reached this conclusion because “important aspects” of the franchise transaction occurred in New York, including the initial in-person discussions.

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171. Letter from International Franchise Association to Governor Hugh Carey (June 30, 1980).
173. N.Y. GEN. BUS. LAW § 681(12) (McKinney).
176. Id.
177. Id.
179. Id.
Moreover, the franchisor’s principal place of business was located in New York.180

And in Schwartz v. Pillsbury, the Ninth Circuit held that the NYFSA applied to a transaction between a California franchisee and a New York franchisor, even though the franchise was located in California and the transaction did not occur in New York.181 The court reasoned that the parties explicitly agreed to a New York choice of law provision, and it was a “fundamental premise of contract law that contracts should be enforced according to their terms.”182

The limits of the NYFSA were finally reached in Century Pacific, Inc. v. Hilton Hotels Corp., where a franchisee brought causes of action under the NYFSA against a franchisor for failing to include a proper prospectus during the franchise sale.183 The franchisees were all based outside of New York, and the franchisor was a Delaware corporation, with its principal place of business in Washington.184 The franchisor argued that the NYFSA did not apply because the parties had no connection to New York, except for a choice of law provision in the franchise agreement that called for the application of New York law.185 The court agreed and held that despite the provision, the NYFSA did not apply because the contract included a carve out clause noting that “nothing in this section is intended to invoke the application of any franchise . . . doctrine of law of the State of New York . . . .”186

The case is notable in that, but for the carve out, the court was ready, willing, and able to apply the NYSFA, even if it would not otherwise apply by its terms, operating under the assumption that the parties’ selection of New York law in the contract would constitute a “constructive offer and/or sale in New York.”187 This would appear to be precisely the type of conduct occurring “wholly outside” the state, that even the Mon-Shore court would acknowledge crosses constitutional bounds.

The NYFSA is unusual for both its breadth and its history. Its rules are surprisingly restrictive, despite the fact that it was enacted after the federal rule came into effect. More surprisingly, despite the relatively modest jurisdictional reach of the language employed by the statute, courts have applied

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180. Id.
181. 969 F.2d 840, 847 (9th Cir. 1992).
182. Id.
184. Id. at *1.
185. Id.
186. Id. The court further rejected the franchisee’s argument that the carve out provision was void as against public policy and explained that for the NYFSA to apply to commerce taking place wholly outside of the state, the parties must expressly demonstrate their intent for New York law to apply.
187. Id. at *5. Other New York dealership laws have not been construed so broadly. See Peugeot Motors of Am., Inc. v. E. Auto Distrib., Inc., 892 F.2d 355, 358 (4th Cir. 1990) (holding that New York Franchise Motor Vehicle Act did not apply to non-New York distributor despite New York choice of law).
the law even where there appears to be no effect on New York or its residents and no valid connection to the state.

III. The Constitutional Limits of State Franchise Laws

A. A Constitutional Analysis of Extraterritorial Reach in State Franchise Law

The extraterritorial reach that has been applied to the FFMA and the NYFSA and, to some extent, even the middle-of-the-road statutes, raises constitutional issues. The Commerce Clause of the U.S. Constitution provides that “Congress shall have Power . . . [t]o regulate commerce . . . among the several states.”¹⁸⁸ For the purposes of the Commerce Clause, commerce is “economic activity.”¹⁸⁹ Furthermore, the Commerce Clause limits state action even in areas, unlike franchising, where the federal government does not implement its own legislation.¹⁹⁰ Any state law that has an impact on interstate commerce will be upheld only if it “regulates evenhandedly to effectuate a legitimate local public interest and its effects on interstate commerce are only incidental . . . unless the burden imposed on such commerce is clearly excessive in relation to the putative local benefits.”¹⁹¹ Direct regulation of interstate commerce is strictly prohibited, regardless of local benefit or need, because it exceeds a state’s authority.¹⁹²

In the context of state regulation, a state law can burden interstate commerce if it “has the practical effect of requiring the out-of-state commerce to be conducted at the regulating state’s direction.”¹⁹³ In such cases, “there is no clear line separating the category of state regulation that is virtually per se invalid under the Commerce Clause, and the category subject to the Pike v. Bruce Church balancing approach.”¹⁹⁴ Courts have generally invalidated statutes that reach into other states by requiring non-residents to obtain the approval of the regulating state before they can implement specific business practices elsewhere.¹⁹⁵ Although the territorial provisions in the

¹⁸⁸. U.S. Const., art. 1, § 8, cl. 3.
¹⁹⁴. Brown–Forman Distillers Corp. v. N.Y. State Liquor Auth., 476 U.S. 573, 579 (1986). The Pike balancing approach requires the court to weigh the local benefits of the purportedly infringing statute against any incidental burdens the statute may impose on interstate commerce. Pike, 397 U.S. at 142 (“Where the statute regulates evenhandedly to effectuate a legitimate local public interest, and its effects on interstate commerce are only incidental, it will be upheld unless the burden imposed on such commerce is clearly excessive in relation to the putative local benefits.”).
¹⁹⁵. See Brown–Forman Distillers Corp., 476 U.S. at 573 (holding that New York’s regulation of liquor pricing had been “projected” into other states because it required distillers to seek the approval of New York State Liquor Authority before lowering the prices elsewhere); see also Healy, 491 U.S. at 336 (holding that Connecticut violated the Commerce Clause because it “require[d] out-of-state shippers to forgo the implementation of competitive-pricing schemes in
New York and Florida statutes certainly appear to fall into this category, challenges to them have been judicially rebuffed. Even when a franchisor specifically argued that the NYFSA violated the Commerce Clause because it governs out-of-state franchises sold to out-of-state parties that will not be operated within New York, the court held that New York had a valid interest in maintaining the integrity of franchise transactions and that in all the situations the statute regulates “either the offeror or offeree will presumably be engaged or intending to engage in business in New York. . . .”

This line of reasoning seems to contradict the more sound reasoning of the U.S. Supreme Court in *Edgar v. MITE Corp.* In *Edgar*, the Court invalidated an Illinois statute requiring review of tender offers of security for any corporation seeking a takeover of an corporation that had (1) principal executive office in Illinois and (2) “at least 10% of its stated capital and paid in surplus represented in Illinois.” The Court determined that the Illinois law was a direct restraint on interstate commerce because, among other reasons, tender offers are usually communicated interstate and the regulation could easily be employed where none of the parties involved were residents of Illinois.

Furthermore, courts have not properly addressed what interest, if any, states have in regulating franchises that are not owned by residents and will not be operated within that state. Most of the middle-of-the-road and broad states require application of their franchise regulations to franchisees as long as an offer was made or accepted within the state. With today’s portable methods of communication, that in essence means that if a Washington resident were to send an offer while on vacation in New York to an Oregon resident for a franchise to be operated in Oregon, arguably New York franchise law applies. The result is absurd and would allow New York to regulate franchises that never have any meaningful impact on New York or connection with it. Although a few state statutes include exemptions to guard against such a situation, not all do. Even more troubling is the fact that courts in New York and Florida are willing to impose their state’s franchise statutes even when there have been no contacts with the state other than a choice of law provision. In light of changes in the economy, and more recent case law from the Supreme Court, the few older cases that have addressed

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198. *Id.*
199. Or Washington law, if the offer violated Oregon’s franchise disclosure requirements. Or Oregon law!
the constitutionality of state franchise statutes may no longer withstand close scrutiny.200

B. The Balance of Information in the Age of the Internet

Even if extraterritorial provisions do not directly regulate out-of-state commerce, they continue to do so indirectly. For any state to regulate interstate commerce indirectly, a legitimate local public interest is necessary and the effects on interstate commerce still must only be incidental. The history of franchise regulation demonstrates that states enacted these laws with the intention of protecting their citizens and residents from perceived abuses by franchisors, abuses driven largely by lack of knowledge and experience. There is no question that protecting citizens against fraud is a legitimate state interest.

But these statutes were hastily enacted201 in response to the unregulated franchise world that existed circa 1970. The world is not now what it was then. Not only are there now federal regulations to protect franchisees from potential fraudulent conduct, but there has also been a dramatic change in the access individuals have to information about businesses, finances, and the law. The Internet, which did not exist in the 1970s, is integral to modern business, so much so that franchisors rate it “as the top way to recruit franchisee prospects.”202 Accordingly, the states’ legitimate interest in regulating franchise sales has diminished over time.

Many of the state franchise statutes are overbroad and overreaching in that they purport to regulate franchise activity that does not involve state residents and occurs entirely outside the state. Although there are statutes that properly limit their reach, most notably California, to the extent states continue to regulate franchises free from rational limitations (either directly by regulators or indirectly by allowing civil suits to enforce their laws), those laws may exceed the proper constitutional bounds of state authority.

IV. Conclusion

The rush to enact state franchise laws reflected an understandable (albeit a heavy-handed and paternalistic) concern for the franchisee and an impa-

200. A full discussion of the constitutional limits on state exercise of jurisdiction over interstate commerce is beyond the scope of this article and merits its own lengthy discussion.
201. For example, Washington, one of the first states to enact a franchise law, notably omitted any definition of the key term “in this state” in its territorial provision. As a result, the legislature had to amend the statute in 1991. The exact same thing happened in Maryland, although that state’s legislature acted much more quickly to address the problem. Similarly, Michigan has a definition for the phrase “in this state” and no corresponding limitation in the statute that would purport to limit its reach to activity occurring “in this state.” Many of the narrow states have failed to define the key phrase “place of business.” As a result of the consistently poor drafting across these jurisdictions, the meaning of these phrases is still being litigated to this day.
tience among the states for federal intervention. The current statutes are outdated and underdeveloped with territorial provisions that are generally overbroad and do protect the interests for which they were enacted. Practitioners should carefully evaluate the reach of a given franchise statute to determine whether it in fact applies to the parties’ relationship, or whether its reach is limited by legislative intent or constitutional considerations.
The legal definition of a franchise is an issue that has plagued business and franchise practitioners since franchise regulation began. Businesses have often called their contractual relationships a “license,” a “distributorship,” or something else, either in an effort to avoid franchise regulation, or out of an honest belief that they were not entering into a franchise relationship, only to later discover that they had actually established a franchise. Because franchise laws cannot be waived, and because they are liberally construed to accomplish their purpose of protecting franchisees, the parties’ intent is not determinative. Thus, whether a business relationship is a franchise depends upon the application of the relevant statutory definition to the facts underlying the relationship.

However, there is no uniform definition of a franchise, making this determination less than straightforward. The Federal Trade Commission Rule on Franchising (FTC Rule) and numerous state laws each define a franchise, with each definition having differing judicial interpretations. In addition, certain states have enacted both presale disclosure laws and dealer and franchise relationship laws, each of which may define a franchise in a slightly different way. Inconsistent statutory definitions in different states add to the confusion because a particular relationship may fall within the definition of a franchise in one state but not in another. And, finally, judicial review often occurs after the parties have done business for years, focusing on a fac-

2. This article focuses on circumstances where treatment of a franchise is not intended or considered at the onset of the relationship. In those states where there are no registration, dealer, or franchise relationship laws, planning can more easily avoid potential liability by focusing on the FTC Rule. One common method is the elimination of payment of a fee or structuring the relationship to fall within one of the exemptions under the FTC Rule. See discussion infra Part II.C.
tual determination of whether the elements of a franchise are then present—facts that may be different than they were at the inception of the relationship. Over the years, many commentators have examined this problem and sought to define what is inherently indefinite: the inadvertent or “accidental” franchise.

Any business that licenses a trademark or distributes licensed products must traverse this legal minefield. Susceptible arrangements may include strategic branding alliances, joint ventures, sales agency agreements, distribution cooperatives, and technology licenses. Ultimately, the task of avoiding an inadvertent franchise will remain fraught with uncertainty; the most one can do is to diminish the possibility of an unpleasant surprise for parties intending an entirely different relationship.

I. Why This Issue Matters: Effects of Failing to Comply with Franchise Laws

Registration and disclosure laws. Those deliberately intending to offer franchises understand the challenges associated with this decision. These challenges include compliance with FTC rules relating to disclosure, such as the duty to provide current and accurate prescribed information to prospective franchisees. In addition, if the franchisor intends to offer franchises in one of the states that require registration of the offer in advance, those statutes often require state-specific presale disclosures, contract terms, or both. Failure to comply with the FTC Rule or state disclosure or registration laws exposes the franchisor, and in some cases its officers, to liability arising either from a regulatory enforcement action filed by state administrators or civil claims asserted against the franchisor (and its officers) by a putative franchisee.6 If a franchise is not intended, as may occur with a license agreement or


6. The FTC Rule does not provide for a private right of action, but many “Little FTC Acts” provide for a cause of action for violation of the federal or state disclosure laws. See Dale E. Cantone, Kim A. Lambert & Karen C. Marchiano, So It Really is a Franchise: Bringing Non-Compliant
an agreement to distribute a branded product, the applicability of these pre-sale regulatory requirements may mean substantial unexpected costs and liability.

State relationship laws. In addition to franchise presale disclosure statutes, many states also have enacted franchise or dealer relationship laws that require compliance with termination requirements, including prohibitions against termination of the relationship without good cause. Because the parties often do not consider the application of these laws when a sales or distribution relationship is established, and because the definition of a franchise varies by state, the first notice that a licensor or manufacturer may receive of the application of these laws is the service of a lawsuit. By that time, the licensor or manufacturer is already deep in the franchise minefield and is stuck trying to determine how to escape it.

II. Basic Definitions of a Franchise

Federal definition of a franchise. The FTC Rule defines a franchise as a relationship that has the following three elements: (1) the franchisee receives a license for, or uses, the franchisor’s trademark; (2) the franchisor exerts significant control over or provides significant assistance to the franchisee; and (3) the franchisor charges a direct or indirect fee over a designated threshold anytime during the first six months of the relationship. If these elements are met, the franchisor must provide presale disclosures prescribed by the FTC Rule in the absence of an exemption or exclusion from the FTC Rule.

State definition of a franchise. The definition of a franchise under state laws often parallels the federal definition, but with some critical differences. Although many state definitions have a similar second element (control and assistance), some states modify this element or describe it differently. The modifications tend to fall into one of two categories: a “marketing plan” requirement or a “community of interest” requirement.

In states that use the marketing plan element, a franchise exists where, in addition to the trademark and fee elements, the franchisor grants the franchisee the right to offer, sell, or distribute goods under a marketing plan that the franchisor suggests or prescribes. In contrast, in states that use the community of interest element, a franchise exists where, in addition to the trademark and fee elements, the franchisee’s business or the sale of the franchisor’s...
goods includes an ongoing financial interest shared by the franchisor and the franchisee.9

Importantly, all three elements of the franchise definition must be present or the relationship falls outside of the definition of a franchise, and the FTC Rule and state laws will not apply. Therefore, avoiding treatment of a relationship as a franchise involves, at the most basic level, elimination of one of the definitional elements of a franchise. The challenge with this approach is that the vast majority of accidental franchises occur not where there is a clear trademark license, substantial assistance or control, and a defined fee, but rather in those areas where the inquiry is inherently fact-dependent, such as implicit permission to use a trademark or an indirect fee. The focus in avoiding the accidental franchise therefore should be careful attention to the facts and circumstances that courts consider important for each element in the relevant jurisdiction.

A. Trademark License—Indirect Licenses and Substantial Association with a Trademark

Given the inherently subjective nature of the term “substantial,” it is not surprising that court decisions applying state franchise statutes disagree on what kind of association with a trademark is “substantial” for purposes of the statutory definition of a franchise.10 Although there are some variations in the statutory definitions of “substantial association” with an alleged franchisor’s trademark, in most states, courts examine the alleged franchisee’s actual use of the mark in the marketplace after the business relationship was created to determine whether that association is substantial, with, of course, the benefit of hindsight. This makes preemptive avoidance of this element particularly difficult. Nonetheless, courts commonly look at four factors to determine whether that association is substantial: (1) the alleged franchisee’s percentage of sales or profits associated with the trademark, (2) a close association as demonstrated by the nature and extent of the alleged franchisee’s actual use of the mark, (3) the degree to which the public associates the franchisor’s mark with the franchisee’s business, and (4) the financial harm that would be suffered by the alleged franchisee due to termination of the agreement and loss of the use of the mark.12

9. These states include Minnesota, Nebraska New Jersey, Wisconsin, and Missouri.
10. See Oates, McCarthy & Berry, supra note 3, which has an extensive state-by-state analysis of case law involving substantial association.
11. Oates, McCarthy & Berry, supra note 3 (describing authorized use statutes (Iowa and New York), product distribution statutes (Michigan and Connecticut), and actual use statutes (California, Connecticut, Idaho, Illinois, Indiana, Maryland, North Dakota, Oregon, Virginia, and Washington)).
12. Oates, McCarthy & Berry, supra note 3 (discussing Connecticut law). See also Cooper Distrib. Co. v. Amana Refrigeration, Inc., 63 F.3d 262 (3d Cir. 1995) (applying New Jersey law and finding a sufficient trademark license where the franchisee was the manufacturer’s exclusive distributor in a four-state territory for thirty years); Kinsley Grp. Inc. v. MWM Energy Sys., 3:12cv1286, 2014 WL 4740577 (D. Conn. Sept. 23, 2014) (in finding substantial association,
To some degree, the first and the fourth factors are related. Naturally, if the alleged franchisee’s percentage of sales or profits from the relationship with the alleged franchisor is greater, the financial harm that would be suffered by the alleged franchisee from the termination of the relationship likewise is greater. None of the statutes sets a particular percentage that would constitute “substantial association,” but the higher the percentage of sales or profit, the greater the likelihood that substantial association will be found. Generally, any percentage greater than fifty percent is likely to be considered substantial association. Further, although there is no minimum threshold in many states, absent other facts leading to a different conclusion, a percentage smaller than twenty percent is less likely to be considered substantial. In fact, some regulators have determined that a relationship below the twenty percent threshold is not substantial and therefore excluded from the application of franchise laws. It should be noted, however, that even these percentage guidelines are uncertain in that they are not consistently applied, and the terms of the calculation vary. What is even more troubling the court applied a “most or all formulation,” asking whether fifty percent or more of the franchisee’s business came from its relationship with the franchisor).

13. See Oates, McCarthy & Berry, supra note 3; Dittman & Greer, Inc. v. Chromalox, Inc., No. 3:09-cv-1147, 2009 WL 3254481 (D. Conn. Oct. 6, 2009) (rejecting the idea that any particular percentage of revenue will be sufficient for substantial association; the plaintiff derived forty-two percent of sales and thirty-four percent of gross profits from selling the defendant’s products, which the court found significant, but on balance with other factors, insufficient to make it a franchise).

14. One court has imposed a bright line standard that requires no less than fifty percent of the franchisee’s business to be associated with the franchisor’s trademark (interpreting Connecticut law). See Echo, Inc. v. Timberland Machs. & Irrigation, Inc., 661 F.3d 959, 966 (7th Cir. 2011); contra James v. Whirlpool Corp., 806 F. Supp. 835 (E.D. Mo. 1992) (sales or profits being greater than fifty percent were not dispositive since the arrangement was not exclusive and distributor sold other products).

15. See, e.g., Kinsley Grp. Inc., supra note 12 (finding no substantial association where the plaintiff derived less than ten percent of its revenue from the relationship, stating the relevant franchise law was not intended to cover relationships “involving only a minute percentage of business”) (citing Grand Light & Supply Co. v. Honeywell, Inc., 771 F.2d 672 (2d Cir. 1985) (finding no franchise where the plaintiff derived less than three percent of its sales from the defendant’s products)).

16. For example, the FTC excludes from its requirements fractional franchises, which it defines as a franchise relationship where the franchisee, or its current directors or officers, or any current directors or officers of a parent or affiliate, have more than two years of experience in that business, and the parties expect sales will not exceed twenty percent of the franchisee’s total sales during the first year. 16 C.F.R. § 436.1(g). Similarly, for a business relationship to fall within the franchise law, New Jersey requires that more than twenty percent of the franchisee’s gross sales are derived or intended to be derived from the franchise, and that the gross sales exceed $35,000 in the twelve months preceding a lawsuit under the act. N.J. STAT. § 56:10-4(a). See also Ocean City Express Co. v. Atlas Van Lines, Inc., 194 F. Supp. 3d 314 (D.N.J. 2016) (interpreting the New Jersey twenty percent requirement and denying summary judgment where there was a genuine issue of whether the parties “intended” for gross sales to exceed twenty percent of overall revenue); B-Jays USA, Inc. v. Red Wing Shoe Co., No. 2:15-cv-021812, 2015 WL 5896151 (D.N.J. Oct. 6, 2015) (holding New Jersey franchise law did not apply where it was clear that sales in the twelve months preceding the suit did not reach $35,000, noting that it had to be gross sales between the plaintiff and the defendant, not simply the plaintiff’s overall gross sales).

17. See Oates, McCarthy & Berry, supra note 3, at 131 nn.30–35.
for a business attempting to avoid the application of franchise laws is that any relationship may evolve over time; a relationship that does not initially involve substantial association with a trademark may become one that does. This factor is particularly subject to change over time because the percentage revenues from the trademark will almost certainly change.

Similarly, the second and third factors are related: greater use of the alleged franchisor’s trademark likely will result in greater public recognition of the relationship between the alleged franchisor and franchisee. With the exception of those states that specifically define substantial association by regulation or statute, the following facts may be indicative of public association between the franchisee and the alleged franchisor’s mark: (1) a long period of exclusive use by the alleged franchisee,18 (2) a restriction on the alleged franchisee’s ability to sell competing products,19 (3) increased use of the trademark without the alleged franchisor’s objection,20 and (4) advertising by the franchisee that is known to the alleged franchisor and/or recommendations from the alleged franchisor regarding advertising.21 Courts are more likely to find that substantial association with an alleged franchisor’s trademark exists in cases with longer-lasting, exclusive relationships, particularly those where the parties cooperate in product promotion and advertising.

B. Significant Control, Marketing Plan, or Community of Interest: Is This Element “a Given”?

The second element in the franchise definition is the significant control of or assistance to the franchisee22 or the existence of a community of interest. The FTC Rule and most state laws focus on an alleged franchisor’s signifi-

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18. Cooper Distrib. Co., v. Amana Refrigeration, Inc., 63 F.3d 262 (3d Cir. 1995) (franchisee was the manufacturer’s exclusive distributor in a four-state territory for over thirty years); contra Rudel Mach. Co. v. Giddings & Lewis, Inc., 68 F. Supp. 2d 118 (D. Conn. 1999) (finding no substantial association where sales of the manufacturer’s products were only forty-one percent of the representative’s business, noting that the alleged franchisee would have to show its business is exclusively or nearly exclusively associated with the alleged franchisor’s trademark, and that the duration of the relationship is not a significant factor); Hartford Elec. Supply Co. v. Allen-Bradley Co., 736 A.2d 824 (Conn. 1999) (the relationship does not have to be exclusive or complete, and it did not matter that the distributor also sold products of other manufacturers).


20. See Ill. Admin. Code, tit. 14, § 200.103 (“A contractual prohibition on use of the franchisor’s name or mark must be policed and enforced to insure that the name or mark is not being substantially used without the franchisor’s knowledge”).


22. See 16 C.F.R. § 436.1(h)(2). This examination considers the entire franchise operation and not merely a particular product or service. Note also that the FTC and some state laws exempt fractional franchises, defined in the FTC Rule as a franchise relationship where the franchisee, its current directors or officers, or any current directors or officers of a parent or affiliate, have more than two years of experience in that business, and the parties expect sales will not exceed twenty percent of the franchisee’s total sales during the first year. 16 C.F.R. § 436.1(g).
cant control of or assistance to the franchisee. Many states have a similar test that relies on whether the franchisor provides a marketing plan or assistance. In contrast, Minnesota, New Jersey, Wisconsin, Missouri, and some others require a “community of interest,” a test that focuses on the amount of investment the purported franchisee must make under the agreement and the importance of the financial relationship to the alleged franchisee.

**Significant assistance or control.** Under the FTC Rule, indicators of control include approval of site location for unestablished businesses, design and appearance requirements, production controls, personnel policies, restrictions on customers or sales areas, required accounting practices, designation of hours of operation, and providing marketing or management advice. Quality and other controls necessary to protect the franchisor’s rights in its trademarks (such as proper display of the mark or a right of inspection) are not evidence of control for franchise definition purposes. Significant assistance to a franchisee under the FTC Rule will be found where the franchisor provides sales, repair, or business training; accounting systems; management, marketing, or personnel advice; assistance with site location; operating or training manuals; and system-wide marketing.

**Marketing plan or assistance.** States that define franchises by requiring a marketing plan or assistance focus on similar factors. For example, California examines the following factors: minimum purchase obligations, product and sales training, provision of sales or demonstration kits, mandatory purchasing requirements, prohibitions on carrying competing merchandise, designation of specific trade dress, financial reporting requirements, and sales protocols. Note that virtually any product distribution agreement will in-

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23. See FTC guidance on the “significant control or assistance” element in its *Franchise Rule Compliance Guide*, supra note 5. The states of California, Connecticut, Illinois, Iowa, Maryland, Michigan, New York, North Dakota, Rhode Island, Virginia, and Washington use standards similar to the FTC Rule.


27. Wis. Stat. § 135.02(1).

28. See Missouri Beverage Co. v. Shelton Bros., Inc., 796 F. Supp. 2d 988 (W.D. Mo. 2011), aff’d, 669 F.3d 873 (8th Cir. 2012) (finding distributorship was not a franchise because there was no trademark license, no permission to use the trademark, and no community of interest, and because the distributor was not financially dependent upon the alleged franchisor).

29. See FTC *Franchise Rule Compliance Guide*, supra note 5.

30. See id. Of course, the challenge here is limiting applicable controls to only those required to protect the marks and nothing further. Note also that “control” for purposes of the definition of a franchise may be different than “control” as applied in other franchise contexts, such as franchisor vicarious liability for franchisee torts. See e.g., Kevin M. Shelley & Susan H. Morton, “Control” in Franchising and the Common Law, 19 Franchise L.J. 119 (Winter 2000).


clude one or more of these elements. For example, a court found that a manufacturer prescribed a marketing plan under California law where it required a dealer to advertise the manufacturer’s products intensively, conduct a variety of promotions, and carry the manufacturer’s array of accessory sales devices.\(^33\) Similarly, this element was satisfied under North Dakota law where distributors marketed products pursuant to a comprehensive advertising and promotional program developed by the supplier, and the supplier reserved the right to screen and approve all promotional materials.\(^34\)

**Community of interest.** Instead of assessing control and assistance, a number of states utilize the “community of interest” test.\(^35\) Some courts have held that this requirement can be met by as little interaction as the sharing of revenue from a common source.\(^36\) In addition, this element has been found where the dealer purchased products from the seller\(^37\) and even where the alleged franchisor received a rebate from a supplier of the alleged franchisee.\(^38\) But of course, these decisions are far from consistent.\(^39\)

To add to the confusion, some courts use tests that sound surprisingly similar to the inquiry of whether there is a substantial association with the franchisor’s trademark.\(^40\) For example, in *Instructional Systems, Inc. v. Computer Curriculum Corp.*,\(^41\) after examining authority from other states that have similar community of interest statutes, the New Jersey Supreme Court set forth a two-prong test for this determination: (1) whether the alleged franchisee makes a substantial franchise-specific investment that (2) is required by agreement or by the nature of the business and that would otherwise be of little or no value without the relationship.\(^42\)

Interestingly, when considering whether the alleged franchisee had made a substantial franchise-specific investment, the *Instructional Systems* court noted factors that could also indicate control or assistance under the control/assistance test. These factors included the obligation that the dealer

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34. Sims & Trice, *supra* note 3 (citing Meadow Fresh Farms, Inc. v. Sandstrom, 333 N.W.2d 780 (N.D. 1983)).
35. Generally, these states include Hawaii, Minnesota, Mississippi, Missouri, Nebraska, New Jersey, South Dakota, and the District of Columbia. Wisconsin uses the “community of interest” element to define “dealership” in its Fair Dealership Law (see WIS. STAT. § 135.02(3)(a)) but uses the “marketing plan” element to define “franchise” in its Franchise Investment Law (see WIS. STAT. § 553.03(4)(a)(1)).
40. One commentator noted the apparent interrelationship between the two analyses. See Mark H. Miller, *Unintentional Franchising*, 56 ST. MARY’S L.J. 301, 312–17, nn.52–56 (2005).
42. Id. at 140–41.
must maintain four sales representatives, maintain adequate facilities to promote the product, submit monthly sales forecast reports to the alleged franchisor, and the alleged franchisor’s retention of the right to inspect books and records. The court also noted that the distributor provided training to sales personnel; provided brochures; shared the cost of model demonstration; and cooperated in sales, marketing, and service activities. The court found it significant that the franchisee was prohibited from selling products that competed with the franchisor’s products. When the court considered the second prong of its community of interest test, it noted that ninety-seven percent of the revenue that the franchisee received was from the sale of the franchisor’s products and concluded there was a community of interest. Other cases doing a similar analysis under this New Jersey test have found that thirty-eight percent was insufficient, while seventy-six percent was sufficient.

Clearly, the community of interest test is as fact-dependent as, and perhaps even vaguer than, the control or assistance test. To add to the inconsistency, one court described the primary issue as being whether the consuming public perceives the seller and the dealer as one and the same.

One case in particular illustrates the broad reach of the community of interest test and the unexpected results that it may yield. In Girl Scouts of Manitou Council, Inc. v. Girl Scouts of the United States of America, Inc., the Seventh Circuit applied the Wisconsin Fair Dealership Law (WFDL) to the relationship between the national Girl Scout organization and its local troop. The WFDL provides that a dealership includes an arrangement “by which a person is granted the right to sell or distribute goods or services, or use a trade name, trademark, service mark, logotype, advertising, or other commercial symbol, in which there is a community of interest in the business of offering, selling, or distributing goods or services at wholesale, retail, by lease, agreement, or otherwise.” The statute defines a community of interest as “a continuing financial interest between the grantor and grantee in either the operation of the business of offering, selling, or distributing goods or services or in the distribution of such goods or services.”

43. Id.; see also Engines, Inc. v. MAN Engines & Components, Inc., No. 10-277 (RMB/KMW), 2010 WL 3021871 (D.N.J. July 29, 2010) (finding likelihood of success on the merits of the franchise claim and the existence of a community of interest and noting that the Third Circuit’s “indicia of control” are the “hallmark” of the community of interest: termination of the arrangement would cause the dealer to lose substantial investments it had made in tangible and intangible equities; further, even where the parties’ interests did not perfectly align, it was enough that they were financially interdependent and coordinated their activities for common goals).
45. Atl. City Coin & Slot Serv. Co., Inc. v. IGT, 14 F. Supp. 2d 644, 663 (D.N.J. 1998); see also Cooper Distrib. Co. v. Amana Refrigeration, Inc., 63 F.3d 262 (3d Cir. 1995) (finding eighty-five percent sufficient). Note also that New Jersey has a de minimis threshold meant to exclude smaller relationships, discussed supra note 16.
46. Cooper Distrib. Co., 63 F.3d 262 at 271.
47. 549 F.3d 1079 (7th Cir. 2008).
48. WIS. STAT. § 135.02(3).
eration of the dealership business or the marketing of such goods or services."  

In Girl Scouts, a local Girl Scout troop asserted that the WFDL applied to its relationship with the national Girl Scout organization and that the statute prevented the national organization from terminating their agreement. Since the local troop used Girl Scout trademarks in the sale of cookies and paid fees to the national organization, the sole criterion that needed to be met was the community of interest element. The court noted that the local troop devoted 100 percent of its time to scouting and received almost 100 percent of its revenue from offering Girl Scout goods and services, resulting in troop revenue of almost $1 million a year. Under these circumstances, the court had little trouble finding that a community of interest existed and that the WFDL applied.

The Girl Scouts case demonstrates that almost any relationship that involves the sale of goods and services may meet the second element of a franchise, even where that type of relationship likely was not within the intent of the state legislature. This has led one commentator to assert that meeting the second element of the franchise definition “is a given.”

This presumption, of course, limits the ability of a licensor to avoid application of franchise laws. To the extent that the community of interest test applies, structuring a relationship so as to avoid substantial association with a trademark may in turn diminish the likelihood of a finding of community of interest. Advisable practices include avoiding exclusive licenses, avoiding prohibitions against selling competing products, limiting mandatory investments by the licensee or distributor, and monitoring the extent to which the licensee or distributor is dependent upon the relationship.

C. Payment of a Fee—Indirect Fees

Federal Rule. The last definitional element of a franchise is a fee paid by the franchisee. Under the FTC Rule, a “required payment means all consideration that the franchisee must pay to the franchisor or an affiliate, either by contract or by practical necessity, as a condition of obtaining or commencing operation of the franchise.” To satisfy this element, the total of the required payments or payment commitments, made before the agreement is signed or within six months after commencing operation of the franchisee’s business, must be more than $570. The determination of whether a sufficient fee has been paid includes all payments that the franchisee must pay to the franchisor or its affiliate for the right to associate with the franchi-

49. Wis. Stat. § 135.02(1).
51. See 16 C.F.R. § 436.1(h).
52. Id.
53. 16 C.F.R. § 436.8(a)(1). Note that the exemption amount is adjusted for inflation every four years.
sor and market its goods. This includes not only simple franchise fees, but also other payments that the franchisee is required to pay to the franchisor or an affiliate, by contract or by practical necessity. Payments can include rent; advertising assistance; required equipment and supplies; training; security deposits; escrow deposits; non-refundable bookkeeping charges; promotional literature, including promotional videos; payments for services to establish the business; equipment rental; and continuing royalties on sales. The FTC Rule excludes payments for merchandise to be used for resale made at a bona fide wholesale price, provided that the party is not required to purchase amounts in excess of what a reasonable businessperson would purchase. As the foregoing discussion indicates, any payment that is made as a condition to obtaining or commencing a franchise operation, whether required by contract or by necessity, may fall within the definition of a franchise “fee.”

State laws. The franchise fee element is similar under state laws. For example, Illinois defines a franchise fee as “any fee or charge that a franchisee is required to pay directly or indirectly for the right to enter into a business or sell, resell, or distribute goods, services or franchises under an agreement, including, but not limited to, any such payment for goods or services.” Other states have similar definitions and often specifically include fees charged for territories or turnkey operations. Like other elements of the definition of a franchise, the fee element has a very broad scope: it is any fee, direct or indirect, paid to the franchisor or its affiliates for the right to do business or that is necessary for the business. It is also important to note that some state laws do not require the payment of any fees at all in order for a business relationship to fall within the scope of a franchise or dealership law. Similarly, some states require a fee but do not require a minimum amount.

Many states exclude certain purchases from the definition of a franchise fee, such as purchases for products that are intended for resale, purchased at a bona fide wholesale price, typically with the limitation that the purchases cannot exceed quantities required. Some state statutes exclude other goods or services that are typically required to conduct any business, such as loans, fixtures, real estate or equipment leases, and similar expenses, provided that

54. Laethem Equip. Co. v. Deere & Co., Bus. Franchise Guide (CCH) ¶ 13,918 (E.D. Mich. Aug. 14, 2007) (denying summary judgment where there was a disputed issue of fact over the fee: dealerships had to pay for required training videos, and when they complained about paying, the manufacturer allegedly said failure to use the videos would be grounds for termination).
56. Id.
57. Id.
58. 815 ILL. COMP. STAT. § 705/3(14).
59. See CAL. BUS. & PROF. CODE § 20007; WASH. REV. CODE § 19.100.010(8).
60. These states include Arkansas, Connecticut, Delaware, Missouri, New Jersey, and Wisconsin.
61. See, e.g., WIS. STAT. § 553.03(4)(3).
62. See, e.g., CAL. BUS. & PROF. CODE § 20007(a); WASH. REV. CODE § 19.100.010(8)(a).
the amount of the fees do not exceed bona fide retail or wholesale prices.63 In interpreting these franchise fee exclusions, courts typically examine the extent to which these investments are either “franchise-specific” or are merely routine business expenses that would otherwise be necessary. For example, fees paid to third parties for training are typically not considered franchise fees.64

One of the most cited examples of an unexpected and costly indirect franchise fee is the case of To-Am Equipment Co. v. Mitsubishi Caterpillar Forklift America, Inc.65 Mitsubishi and To-Am entered into what the parties considered to be a distributorship agreement. When Mitsubishi gave sixty days’ notice that it was terminating the relationship in accordance with the agreement, To-Am sued, asserting that the relationship was a franchise and Mitsubishi’s termination violated the Illinois Franchise Disclosure Act (IFDA). The U.S. District Court for the Northern District of Illinois held that all elements of the definition of a franchise under the IFDA were met. For the fee element, the court found that a payment of $1,600 for various manuals over an eight-year period constituted a franchise fee under the Act. After a jury trial awarding $1.525 million to To-Am, Mitsubishi appealed, challenging the district court’s determination that the relationship constituted a franchise and, particularly, the determination that the charges for manuals constituted a franchise fee. Interpreting Illinois law,66 the Seventh Circuit noted the expansive nature of the definition and affirmed the district court’s entry of judgment.67

The decision in To-Am Equipment Co., is perhaps the most (in)famous example of an indirect franchise fee, but courts find indirect franchise fees in myriad settings. They have included: a mandatory ongoing advertising fee (Illinois law),68 purchases in excess of inventory requirements (Illinois and

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63. See, e.g., WASH. REV. CODE § 19.100.010(8)(c)–(f); MINN. STAT. § 80C.01(9)(e); see also Lofgren v. AirTrona Canada, 677 F. App’x 1002, 1008 (6th Cir. 2017) (affirming district court decision that equipment purchase was an indirect franchise fee where the franchisee paid more than the market value). Note that some cases have found the fact that the seller may make a profit on sales to the alleged franchisee or retain a markup does not necessarily make it an indirect franchise fee, as long as the sale price is still a bona fide wholesale price. See Coyne’s & Co., Inc. v. Enesco, LLC, 553 F.3d 1128 (8th Cir. 2009); Kenaya Wireless, Inc. v. SSMJ, LLC, No. 281649, 2009 WL 763496 (Mich. Ct. App. Mar. 24, 2009); Sports Racing Servs., Inc. v. Sports Car Club of Am., Inc., 131 F.3d 874 (10th Cir. 1997); Corp. Res., Inc. v. Eagle Hardware & Garden, Inc., 62 P.3d 544 (Wash. Ct. App. 2003).
65. 152 F.3d 658 (7th Cir. 1998).
66. See 815 ILL. COMP. STAT. 705/3(14).
67. This case is also notable in that the court rejected an argument that To-Am only purchased goods at a bona fide purchase price, distinguishing its earlier case construing Indiana law (Wright–Moore Corp. v. Ricoh Corp., 908 F.2d 128, 132 (7th Cir.1990)). As the court noted, Indiana’s bona fide purchase exception was broader than the Illinois definition, which limited this exception to those goods that had an established market. To-Am, 152 F.3d at 663. This highlights the importance of looking at the specific state statute involved.
Connecticut law);\textsuperscript{69} an unreasonable minimum initial inventory (Minnesota law);\textsuperscript{70} and, payment of a portion of a franchisee’s required product purchases into a mandatory co-op advertising account controlled by the licensor (Minnesota law).\textsuperscript{71} These indirect franchise fee cases often turn on whether the expenditure was a routine business expense. Simple as it may sound, the line between an ordinary business expense and an indirect franchise fee is a fine one that requires close attention to the applicable state law and the factual circumstances.\textsuperscript{72}

III. Avoiding the Minefield: Recommendations for Avoiding an Accidental Franchise

This discussion demonstrates the challenge faced by distributors, licensors, manufacturers, and their counsel, none of whom wants to walk into a minefield. Few distributors and licensors will intentionally structure a relationship so as to meet the definition of a franchise, especially where the patchwork of federal and inconsistent state laws makes a national approach challenging. Although the legal environment makes it difficult to avoid creating an accidental franchise, the following considerations may be useful to the extent that they are consistent with business goals:\textsuperscript{73}

- \textit{Consider a direct prohibition of use of the licensor’s trademarks}. Although a contractual prohibition is not necessarily dispositive\textsuperscript{74} and may partially

\textsuperscript{69.} See, e.g., Flynn Beverage Inc. v. Joseph E. Seagram & Sons, Inc., 815 F. Supp. 1174, 1179 (C.D. Ill. 1993) (denying motion to dismiss where alleged franchisee was required to purchase excess inventory); Atchley v. Pepperidge Farm Inc., No. 09-35275, 2010 WL 1936275, at *1 (9th Cir. May 14, 2010) (reversing summary judgment based partly on a fee issue, where the manufacturer required distributors to maintain minimum inventory levels, controlled shipments, and required payment for products that had gone stale; the court noted that payments for “mandatory purchase of goods or services” count as franchise fees).

\textsuperscript{70.} Twin Cities Galleries, LLC v. Media Arts Grp., Inc., 476 F.3d 598, 601–02 (8th Cir. 2007) (finding that an unreasonable purchase requirement can be an indirect franchise fee, reversing the district court decision and remanding with directions to confirm the arbitration award); \textit{contra} Coyne’s & Co., Inc. v. Enesco, LLC, 553 F.3d 1128, 1132 (8th Cir. 2009) (finding wholesale markup of thirty-five to fifty percent over manufacturing cost was a normal wholesale markup and thus did not qualify as a franchise fee, noting that minimum purchase requirements would be franchise fees only if the franchisee were required to buy quantities it would not otherwise buy).


\textsuperscript{72.} \textit{Compare id. with} R&A Small Engine, Inc. v. Midwest Stihl, Inc., No. 06-877(DSD/JJG), 2006 WL 3758292 (D. Minn. Dec. 20, 2006) (both interpreting Minnesota law on facts that are substantially the same, \textit{Pool Concepts} finding an indirect franchise fee and \textit{R&A Small Engine} finding a routine reasonable business expense).

\textsuperscript{73.} The recommendations here focus on facts that have been significant in some reported decisions and are hardly a panacea for avoiding treatment as a franchise. Furthermore, they may be inconsistent with business goals.

\textsuperscript{74.} P & W Supply Co. v. E.I. DuPont de Nemours & Co., Inc., No. 89 C 20293, 1991 WL 352614 (N.D. Ill. Sept. 17, 1991) (denying motion for summary judgment and rejecting the defendant’s argument that a direct prohibition of use of its trademark makes substantial association impossible). Note also that although an express prohibition of use of a trademark may remove
frustrate business goals, some courts have at least made reference to the fact that trademark use was not authorized. Prohibited uses should include use on business cards, letterhead, uniforms, vehicles, signage, and any buildings.

- **Carefully scrutinize any exclusive relationship.** Nonexclusive relationships where the licensee sells other products are less likely to be considered franchises due to the substantial association element. In addition, in exclusive relationships, the franchisee’s sales under the franchisor’s mark will necessarily constitute a greater percentage of the distributor’s business, thus increasing the likelihood that a court will find a community of interest (where that standard applies). Even in states that do not apply the community of interest standard, as one commentator has noted, unrecoverable investments often define franchise relationships. The bigger the loss suffered due to termination of the relationship, the greater the likelihood that a court will conclude the relationship constituted a franchise, especially given the remedial nature of franchise statutes and regulations and their broad interpretation.

- **Avoid giving marketing advice or requiring permission in advertising.** If possible, do not contribute or share costs associated with advertising because this type of cooperative promotion confirms association and is typical in the franchise environment. If advertising or promotion is important for business reasons, consider making them optional rather than mandatory. Courts are less likely to consider optional marketing expenses an indirect franchise fee than mandatory marketing expenses.

- **Consider including a disclaimer or other contract provisions that define the intention of the parties to the relationship.** The existence of a franchise depends on factual circumstances and the parties’ conduct, and the case


75. See, e.g., Cooper Distrib. Co. v. Amana Refrigeration, Inc., 63 F.3d 262 (3d Cir. 1995) (discussing New Jersey’s broad construction of what constitutes a trademark license, finding permission to use the trademark where the distributor used the manufacturer’s sign and uniforms); Gabana Gulf Distrib., Ltd. v. GAP Int’l Sales, Inc., 343 F. App’x 258, 259 (9th Cir. 2009). At the very least, a direct prohibition of trademark use ought to prevent some of these circumstances that would otherwise indicate an implicit license.

76. Cooper Distrib. Co., 63 F.3d 262.


78. Jonathan Solish, Unrecoverable Investments Define Franchise Relationship, 26 FRANCHISE L.J. 3 (Summer 2006); see also Am. Estates, Inc. v. Marietta Cellars Inc., No. 10-6763-WJM, 2011 WL 1560823 (D.N.J. Apr. 25, 2011) (community of interest was adequately alleged where wine distributor claimed that it had made “enormous investments” into developing a market for the manufacturer’s wines; despite manufacturer’s claim that it never required investments, it was clear from the distributor’s complaint that the investments were necessary for the success of the arrangement due to the lack of market demand for those wines).
law stresses that the name the parties give to their relationship is irrelevant. Nonetheless, it cannot hurt to include a disclaimer, especially since some courts have assigned importance to the disclaimer in making a decision on the existence of a franchise.\textsuperscript{79} Any contractual disclaimer should also address individual factors that matter in the relevant jurisdiction, such as denial of marketing support or approval in the states that apply that standard.\textsuperscript{80} Although contract terms are not dispositive, it may help to spell out the parties’ intention that the relationship be nonexclusive, that the licensee is permitted to sell other goods (including competing goods), that the sales and/or profits under the agreement are not intended to exceed a particular level of the licensee’s sales and/or profits, and that the licensee retains its independence. Further, in the event that the relationship is later determined to be a franchise, the agreement should define good cause for termination, even if it includes only business justifications of the licensor or manufacturer.

- **Periodically disclaim a franchise relationship in communications.** Again, such disclaimers do not control the definition of the relationship, but may be persuasive in the event of a dispute.\textsuperscript{81}

- **Consider a provision requiring the licensee or distributor to provide notice if the percentage of sales from the manufacturer exceeds a contractual threshold.** This will allow the licensor to be proactive in addressing problems in advance of any termination.

- **Don’t lose sight of what laws apply and if possible structure the relationship so as to eliminate more than one of the franchise definitional factors.** For example, if the relationship is focused in a state without registration, disclosure, or relationship laws, eliminating or deferring franchise fees to avoid triggering the fee element of the FTC Rule will limit the likelihood of unintended treatment as a franchise.

- **Examine applicable exemptions and structure relationships within them.** A single licensee or distributor may be preferable to a patchwork of

\textsuperscript{79} In the following cases, the court at least acknowledged that the parties’ agreement expressly disclaimed any franchise status, never used the word “franchise,” or did not otherwise resemble a franchise agreement: Jerome-Duncan, Inc. v. Auto-By-Tel, LLC, 989 F. Supp. 838 (E.D. Mich. 1997); Adcom Express, Inc. v. EPK, Inc., No. C6-95-2128, 1996 WL 266412 (Minn. Ct. App. May 21, 1996); Kempner Mobile Elecs., Inc. v. S.W. Bell Mobile Sys., LLC, No. 02 C 5403, 2003 WL 2259263 (N.D. Ill. Nov. 7, 2003); Bryant Corp. v. Outboard Marine Corp., No. C93-1365R, 1994 WL 745159 (W.D. Wash. Sept. 29, 1994).

\textsuperscript{80} See, e.g., Garbinski v. Nationwide Mut. Ins. Co., No. 3:10cv1191(VLB), 2011 WL 3164057 (D. Conn. July 26, 2011) (finding evidence of marketing plan in the parties’ written agreement intended to be a mere insurance agency; evidence included requirement that certain marketing materials be pre-approved and conform to the insurance company’s policies, and a clause stating the insurance company would “prescribe rules, regulations, prices and terms” subject to change at any time).

\textsuperscript{81} This is the distribution agreement equivalent of franchisee acknowledgments often included as part of a franchise sale. Regulators and courts often do not consider them binding, but they can be persuasive in the event of a dispute.
local distributors covered by other franchise laws. In addition, in a product distribution environment, drafting or structuring the relationship to ensure that less than twenty percent of the distributor’s revenue comes from sales of the franchisor’s products may avoid treatment as a franchise under federal law and some state laws.

- *When all else fails, comply with the franchise laws.* Although this has its costs, compliance provides the advantage of minimizing franchise-related claims and unexpected liability.

IV. Conclusion

Franchise laws are broadly worded and broadly interpreted in order to afford franchisees great protection. However, clients often wish to avoid subjecting themselves to these statutes because compliance is costly and the potential for liability under them (whether the result of regulatory action or civil litigation) is substantial. To the extent that any one element of the definition can be eliminated from a business arrangement, this likely is the most effective way to avoid creating an inadvertent franchise. Unfortunately, though, the case law shows that doing this is never a sure thing; there are gray areas surrounding each of the three elements of the franchise definition, such that it is impossible to draft around it with absolute certainty. Evolutions in business relationships over time and inconsistencies among state laws and fact-dependent judicial interpretations all make the task even less certain. Although it may at times frustrate business goals, parties may be able to avoid significant liability by taking extra precautions to avoid the more common factors that have led courts to find inadvertent franchises.

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82. It is important to note that a licensor with a single licensee may avoid disclosure obligations under the FTC Rule, but the licensor may still be required to comply with state disclosure or relationship laws.
Location, Location, Location: Effect of the Franchisee’s Bankruptcy on the Franchisor’s Control of Real Estate

Susan V. Metcalfe

When a franchisor takes steps to terminate a franchise agreement, but the franchisee insists on continuing business as usual at premises owned by the franchisor, a battle over control of the real estate often ensues. In addition to protecting its trademarks, the franchisor wants to preserve the locational goodwill built up at the site—goodwill that, in many cases, was garnered through many years of continuous operation at a particular location selected by the franchisor for its visibility, accessibility to customers, or other factors that enhance the business.

Franchisors that own (or hold the master lease to) the subject real property may seek, on an emergency basis, to “evict” franchisees that have failed to cure a material breach of the franchise agreement rather than de-identify the location and risk losing customers to the competitor down the street. A plethora of cases supports their right to do so, awarding injunctive relief and permitting the franchisor to assume operations pending trial on the merits of a termination claim.1

The legal landscape can change significantly, however, if the franchisee files for bankruptcy protection. When that happens, any proceedings to follow through with or enforce the franchise termination and gain possession of the location are subject to an automatic stay. The franchisor may obtain relief from the stay if the franchise agreement and all of its components were effectively terminated before the bankruptcy filing. If not, then the debtor in possession or the bankruptcy trustee has the right to “assume” the franchise agreement, thereby compelling its continuation.2

Matters may become more complicated when the parties have entered into a real property lease in addition to the franchise agreement. If the two are found to comprise a single, indivisible contract and the lease has not been effectively

1. See Part I, infra.
2. See Part II, infra.

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terminated prior to the franchisee’s initiation of the bankruptcy, the debtor or trustee may be able to assume the franchise agreement even if it was terminated pre-petition, thereby prohibiting the franchisor from taking control of the location.³ The debtor or trustee may even be able to assign the franchise agreement (and lease) to a third party purchaser without the franchisor’s consent.⁴

Several key cases discussed below—together with an overview of pertinent Bankruptcy Code provisions as applied in the franchise context—demonstrate that there are quite a few uncertainties and traps for the unwary when a franchisor seeks to control real estate occupied by a franchisee in bankruptcy, and attorneys on both sides should pay close attention to jurisdictional differences concerning the interpretation and application of the Code, as well as the potential effect of unique state laws.

Ⅰ. Backdrop: Repossession of the Franchised Location Outside the Bankruptcy Context

A long line of cases throughout the country holds that, provided the franchisor shows a likelihood of success on the merits of a disputed franchise termination, the franchisor is entitled to immediate possession of the location pending a trial on the merits.⁵ This is because the deprivation of a party’s right to possession and enjoyment of its property constitutes irreparable harm properly remedied by injunctive relief.⁶ The irreparable harm “flows

³. See Part II, infra.


⁵. See, e.g., P.P. & K., Inc. v. McCumber, 46 F.3d 1134 (7th Cir. 1995) (franchisor showed “great likelihood of success” on claim requiring franchisee to vacate franchised premises and stating: “[T]he store, over the years, has developed significant goodwill and good reputation as a Convenient Food Mart in the minds of the consuming public. The loss of such goodwill constitutes irreparable harm.”); 7-Eleven, Inc. v. Spear, No. 10-cv-6697, 2011 WL 830069, at *3 (N.D. Ill. Mar. 3, 2011) (“[I]f deprived of its contractual right to possession of the Store during the pendency of the litigation, 7-Eleven could lose the customers and goodwill associated with that location.”); 7-Eleven, Inc. v. Khan, 977 F. Supp. 2d 214, 234 (E.D.N.Y. 2013) (“[I]t is well-settled that unauthorized interference with a real property interest constitutes irreparable harm as a matter of law, given that a piece of property is considered to be a unique commodity for which a monetary remedy for injury is an inherently inadequate substitute.”); Snelling & Snelling, Inc. v. Martin, No. C 97-4479 FMS, 1998 WL 56995 (N.D. Cal. Jan. 28, 1998) (finding franchisor would lose “intangible benefit” of its location if franchisees remained in premises); Shell Oil Co. v. Altina Assocs., Inc., 866 F. Supp. 536, 541–42 (M.D. Fla. 1994).

from the owner’s inability to make better use of the site, or the owner’s lack of control over features, fixtures, and equipment located at the site.”

The rationale underpinning these cases is the concept that goodwill is comprised of more than just brand recognition; rather, it includes the location and reputation of the business. When a terminated franchisee refuses to vacate the premises, the franchisor is unable to monitor compliance with brand standards and ensure customer satisfaction. The potential loss of business and the tarnishing of the franchisor’s reputation threaten harm that is inherently incalculable and therefore irreparable.

Notwithstanding this line of cases, if the franchisee files for bankruptcy protection, the franchisor’s road to recovering the premises may become substantially more difficult.

II. Case Study: In re Karfakis

Perhaps no case better illustrates the potential effects of the franchisee’s bankruptcy on the franchisor’s attempt to control the real estate than In re Karfakis. In Karfakis, Dunkin’ Donuts of America, Inc. (the franchisor) and Dunkin’ Donuts of Pennsylvania, Inc. (the landlord) took steps to terminate the franchise agreement and real property lease of franchisees that had an “erratic payment history” over the course of the parties’ seven-year relationship. According to the franchisees, following notice of termination, Dunkin’ Donuts orally advised them that they could still sell their business to a third party. The franchisees remained in possession and continued operating for several months, until they found a purchaser who offered to pay the franchisees a substantial price ($320,000) for the business.

Dunkin’ Donuts was unwilling to permit the sale, however, and filed suit in state court seeking an injunction to prevent the franchisees from operating and also seeking an order for possession of the store. The franchisees then initiated a Chapter 11 proceeding, presumably in response to the state court litigation, and moved to assume their franchise and lease agreements so they could assign them to the purchaser Dunkin’ Donuts had previously re-
Dunkin’ Donuts argued that the debtor franchisees could not assume and assign the agreements because they were not property of the bankruptcy estate, having been terminated pre-petition.15

The court disagreed, reasoning that under Pennsylvania law a lease is not terminated until the tenant is physically evicted.16 Although Dunkin’ Donuts had initiated eviction proceedings, the proceedings had not concluded, and the franchisees were still in physical possession of the location. According to the court, the lease’s survival beyond the date of the bankruptcy filing essentially revived the terminated franchise agreement and brought it within the bankruptcy estate as well. The court reasoned that the franchise agreement and lease constituted a single, indivisible agreement and were “inextricably interwoven” because they were both executed on the same date, contained cross default provisions, and one agreement was of “no utility without the other.”18

Ultimately, the court held that the partial pre-petition termination of an integral two-part agreement was ineffective to render the entire agreement terminated pre-petition and thus found that both the franchise agreement and lease survived post-petition and became property of the estate.19 On that basis, the court rejected Dunkin’ Donuts’ motion to modify the automatic stay, contemplating that a sale might proceed—provided the debtors strictly complied with their contractual duties in the meantime—and the proceeds of the sale could then be used to satisfy the creditors.20

Karfakis appears to be unique in that it turned on the court’s application of state real estate law in determining that the lease had not been terminated. Thus, Karfakis’s precedential or persuasive effect may be somewhat circumscribed. Nevertheless, the decision highlights how state-specific laws and jurisdictional variations in the interpretation and application of the Bankruptcy Code, franchise law, and contract principles can radically affect the outcome of any given case.

III. Relevant Bankruptcy Code Provisions and Principles

The outcome in Karfakis was premised upon several key provisions of the Bankruptcy Code, including Section 365(a), which allows a bankruptcy trustee to assume or reject unexpired leases and executory contracts;21 Section 1107(a), which grants to a Chapter 11 debtor-in-possession the rights of

15. Id.
16. Id.
17. Id. at 725 (citing, inter alia, In re Telephonics, 85 B.R. 312, 316 (Bankr. E.D. Pa. 1988)).
19. Id. at 725, 727.
20. Id. at 727.
a bankruptcy trustee under Section 365;\textsuperscript{22} and Section 365(b), which estab-
lishes the requirements for assumption of executory contracts.\textsuperscript{23}

The overarching goal of Section 365 of the Code is to maximize the value
of the debtor’s estate by empowering the trustee to assume executory contracts
(e.g., franchise agreements)\textsuperscript{24} and unexpired leases that benefit the estate and
reject those that do not.\textsuperscript{25} The concept that a debtor can reject a contract “has
its roots in the principle that the debtor may abandon burdensome prop-
erty.”\textsuperscript{26} In addition to the options of rejecting the contract altogether or
assuming the contract and performing thereunder, the debtor also has the option
of assigning the contract or lease to a third party.\textsuperscript{27} The debtor’s option to as-
sume exists even if the contract contains an express provision for termination
upon insolvency.\textsuperscript{28} Likewise, the debtor’s option to assign may be available
notwithstanding an express contractual provision to the contrary.\textsuperscript{29}

The debtor’s ability to assume (or assume-and-assign) a contract is not
without limitation. Because executory contracts and unexpired leases involve
a continuing relationship between the debtor and other parties, Section 365
“gives special treatment to rights and liabilities flowing from these contracts
and leases.”\textsuperscript{30} If the debtor is in default of an executory contract or unexpired
lease, the contract cannot be assumed unless and until the debtor: (1) cures
or provides adequate assurance that it will promptly cure the default; (2) com-
pensates or provides adequate assurance of prompt future compensation for
actual pecuniary loss resulting from the default; and (3) provides adequate
assurance of future performance under the contract or lease.\textsuperscript{31}

The requirement of curing the default extends to non-monetary de-
faults.\textsuperscript{32} The Code makes an exception, however, for commercial leases
where a non-monetary default cannot be cured.\textsuperscript{33} In such cases, the lessee/
debtor may still assume the lease provided that, going forward from the date of assumption, the debtor fulfills all of the lease obligations—monetary and non-monetary—and cures any monetary losses incurred by the lessor.34

The election to assume is an “all-or-nothing proposition”: either the whole contract is assumed or the entire contract is rejected.35 Upon assumption, the debtor’s liabilities under the contract become administrative expenses entitled to priority under Sections 503(b) and 507(a)(2).36 If the contract is assumed, “the debtor is entitled to receive the benefits under the [contract] but, at the same time, is responsible for performing its obligations thereunder.”37

IV. Bankruptcy Provisions as Applied in the Franchise/Lease Context

Property of the bankruptcy estate includes “all legal or equitable interests of the debtor in property as of the commencement of the case.”38 Executory contracts that have not been terminated as of the date of the bankruptcy filing may become property of the estate, either immediately upon filing for Chapter 11 protection, or upon assumption of the contract in question, depending upon the jurisdiction.39 Conversely, contracts that have been terminated pre-petition do not become property of the estate.40 However, the ter-

34. 11 U.S.C. § 365(b)(1).
36. See, e.g., Bildisco & Bildisco, 465 U.S. at 532; In re Trans World Airlines, Inc., 145 F.3d 124 (3d Cir. 1998); In re Taylor, 913 F.2d 102, 106–07 (3d Cir. 1990) (“[T]he ‘assume or reject’ dichotomy means simply that if the trustee wishes to obtain for the estate the future benefits of the executory portion of the contract, the trustee must also assume the burdens of that contract, as an expense of bankruptcy administration (i.e., having priority over all pre-bankruptcy claims of creditors.”); In re Texas Health Enters. Inc., 72 F. App’x 122, 126 (5th Cir. 2003) (“Though § 365 benefits the debtor by allowing it to assume contracts beneficial to the estate, it also puts a specific limitation (the adequate assurance requirement) on which contracts may be assumed, providing a measure of protection for the non-debtor.”).
37. In re Trans World Airlines, 145 F.3d at 136 (citing In re Columbia Gas Sys., 50 F.3d 233, 238–39 & n.8 (3d Cir. 1995)).
39. In re Drexel Burnham Lambert Grp., Inc., 138 B.R. 687, 701 (Bankr. S.D.N.Y. 1992) (holding that executory contracts are property of estate subject to abandonment by rejection, but noting that “how and when executory contracts come into the estate has been the source of continuing controversy and progressive development”); In re Qintex Entm’t, Inc., 950 F.2d 1492, 1495 (9th Cir. 1991) (“An executory contract does not become an asset of the estate until it is assumed pursuant to § 365.”).
40. See Moody v. Amoco Oil Co., 734 F.2d 1200, 1212 (7th Cir. 1984).
mination “must be complete and not subject to reversal, either under the terms of the contract or under state law.”

The Bankruptcy Code does not define the term “executory contract,” but case law and legal scholars have defined it as a contract “in which performance beyond the mere payment of money is due on both sides.” Franchise agreements are universally held to be executory contracts and thus property of the bankruptcy estate.

In the case of any executory contract, the non-debtor party must continue to perform its contractual obligations while the debtor or trustee decides whether to assume or reject the contract. Thus, in the franchise context, the creditor/franchisor would be required to comply with all of its duties under the franchise agreement, such as permitting the debtor to operate as a franchisee, allowing the debtor to use the franchisor’s marks, supplying proprietary products, and providing any contractually required services, pending the debtor’s or trustee’s decision.

Like franchise agreements, unexpired nonresidential property leases also become property of the bankruptcy estate and can be assumed, assigned, or rejected by the debtor or trustee. It is not uncommon for a franchisee to enter into a commercial real property lease with the franchisor or a related entity, often at the same time as the franchise agreement is executed. The interplay between the lease and the franchise agreement can have serious implications when the franchisee files for bankruptcy protection, in addition to those presented in the Karfakis scenario described in Part II.

One such implication favors the franchisor/creditor: where two agreements are integrated or inextricably intertwined, such as the franchise agreement and real property lease in Karfakis, courts have held that the debtor cannot assume the lease obligation without also curing the defaults under the related executory agreement.

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41. Id. at 1212. See also In re Masterworks, Inc., 100 B.R. 149 (Bankr. D. Conn. 1989); In re C.W. Mining Co., 422 B.R. 746 (10th Cir. BAP 2010); In re Making the Dough, Inc., 2009 WL 975170, at *3 (“[d]ebtor’s contractual rights as a franchisee are property of the estate under § 541(a)(1), unless the franchise agreement has been terminated before the bankruptcy case is filed.”); In re Tornado Pizza, LLC, 431 B.R. 503, 510–11 (Bankr. D. Kan. 2010) (“[W]hen a franchise agreement has been terminated for cause prepetition and the termination process is complete with no right to cure when the petition is filed, the debtor does not have a property interest in the franchise on the date of filing and there is no executory contract to assume, even if on the date of filing the debtor remains in possession of the franchised business and continues to use the franchisor’s trademark property.”).


46. See, e.g., In re Szenda, 406 B.R. 574, 582 (Bankr. D. Mass. 2009) (the debtor’s motion to assume a lease agreement would be denied unless the debtor sought approval, via motion or plan, for the assumption of the Subway franchise agreement relating to the leased premises);
Another implication, relating to the timing of assumption or rejection, may be more favorable to the franchisee/debtor. Under Section 365(d)(2) of the Bankruptcy Code, a debtor can wait until confirmation of a plan of reorganization to decide whether to assume or reject an executory contract, such as a franchise agreement. The deadline for assuming or rejecting an independent commercial real property lease is much more limited. Under Section 365(d)(4), a commercial real property lease is deemed rejected unless the debtor assumes it within 120 days from the entry of an order for relief, unless the court grants an extension of up to ninety days, or the landlord consents to a further extension of time. The more restrictive deadline applicable to commercial leases is designed to address problems caused by extended vacancies of space located in shopping centers that reduce customer traffic to other non-debtor tenants.

The question of which time period applies in the case of a commercial real property lease that is integrated or inextricably interrelated with an executory contract—in particular, a franchise agreement—has been the subject of some controversy, and the answer is still uncertain. The scant case law addressing the issue suggests that the longer period may apply, but, as discussed later in Section V, the law is far from settled on this point and has serious implications for the franchisor’s ability to control real property in the face of a franchisee’s bankruptcy.

V. Case Study: In re A&F Enterprises, Inc. II

The Seventh Circuit’s decision in In re A&F Enterprises, Inc. II is one of the few opinions addressing the deadline for the debtor’s assumption or rejection of integrated franchise and real property lease agreements. There, the court grappled with whether the longer time period under Section 365(d)(2) applied to both the lease and the franchise agreement, despite the clear stat-

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50. See In re FPSDA I, 450 B.R. at 392; In re FPSDA I, 450 B.R. at 392; In re Harrison, 117 B.R. 570 (Bankr. C.D. Cal. 1990) (pre-BACPA case addressing the applicability of § 365(d)(2) and § 365(d)(4) to petroleum product franchisees).
51. See In re FPSDA I, 450 B.R. at 392; In re FPSDA I, 450 B.R. at 392; In re Harrison, 117 B.R. 570 (Bankr. C.D. Cal. 1990) (pre-BACPA case addressing the applicability of § 365(d)(2) and § 365(d)(4) to petroleum product franchisees).
utory language of Section 365(d)(4) providing that a nonresidential real property lease must be assumed or rejected within 120 days.\textsuperscript{54}

The court below had ruled that the shorter period applied to the lease and denied the debtors’ motion for stay pending appeal.\textsuperscript{55} The Seventh Circuit reversed with respect to the stay.\textsuperscript{56} But the court’s decision did not create a bright-line rule as to which time period applied, even within the Seventh Circuit, because it turned on the court’s analysis of the relative harms each party stood to suffer if the franchisees’ motion for stay pending appeal were granted or denied.\textsuperscript{57}

The debtors in \textit{A&F Enterprises} were franchisees (A&F) that operated nineteen International House of Pancakes (IHOP) restaurants.\textsuperscript{58} For most of the restaurants, there were three separate contracts: a franchise agreement, a building sublease, and an equipment lease, all of which contained cross-default provisions.\textsuperscript{59} The leased premises could not be used for anything but IHOP restaurants and the leases could not be assigned.\textsuperscript{60} The franchise agreements, by their own terms, automatically expired if A&F lost the right to occupy the leased premises.\textsuperscript{61}

The franchise agreements and leases at issue had not been terminated when the franchisees filed for Chapter 11 bankruptcy protection, and so the franchisees had the choice to assume or reject them as part of the reorganization.\textsuperscript{62} When the franchisees failed to assume the leases within 120 days or seek an extension to do so, IHOP moved the court to deem the leases rejected.\textsuperscript{63} The bankruptcy court and district court granted the motion and also deemed the franchise agreements expired because A&F lost the right to occupy the premises by failing to assume the leases within the statutory deadline.\textsuperscript{64}

The franchisees sought a stay pending appeal, arguing that the longer time limit of Section 365(d)(2) controlled because “the building leases are just one part of the larger franchise arrangement with IHOP.”\textsuperscript{65} IHOP argued the test of Section 365(d)(4) “plainly controls, leaving no room for an exception for franchise-bound leases.”\textsuperscript{66} The Seventh Circuit’s succinct description of the true dilemma facing it bears repeating in full:

When a franchise agreement and a lease are inseparable, one time limit or the other will control both. In the same way that applying § 365(d)(2)’s time limit to the entire arrangement creates an “exception” for certain leases, applying

\begin{itemize}
\item \textsuperscript{54} \textit{Id.} at 767.
\item \textsuperscript{56} \textit{In re A&F Enters.}, 742 F.3d at 770.
\item \textsuperscript{57} \textit{Id.} at 769–70.
\item \textsuperscript{58} \textit{Id.} at 765, n.1.
\item \textsuperscript{59} \textit{Id.} at 765, n.2.
\item \textsuperscript{60} \textit{Id.} at 766.
\item \textsuperscript{61} \textit{Id.} at 767.
\item \textsuperscript{62} \textit{Id.} at 765.
\item \textsuperscript{63} \textit{Id.}
\item \textsuperscript{64} \textit{Id.}
\item \textsuperscript{65} \textit{Id.} at 766.
\item \textsuperscript{66} \textit{Id.} at 767.
§ 365(d)(4)’s time limit creates an “exception” for certain franchises. Granted, the two possibilities are not perfectly symmetrical because one result permits something the code forbids (assuming a lease beyond 120 days) while the other result prevents something the code permits (assuming a franchise agreement beyond 120 days). This is a distinction without a difference, however, because a legal entitlement is lost either way: Either franchisees lose the right to assume the franchise agreements at any time before confirmation of a plan, or lessors lose the right to have their leases assumed or rejected within 120 days. Creating an exception is unavoidable, so we have no choice but to look beyond the text.67

In the final analysis, the court did not have to create an exception: it limited its decision to whether the bankruptcy court’s orders should be stayed pending resolution of the appeal on the merits,68 and the parties settled and voluntarily dismissed the case prior to any further ruling.

In reversing the lower court and granting the stay, the Seventh Circuit applied a standard that mirrored that for granting a preliminary injunction and found that a balancing of the harms weighed in favor of the franchisees.69 “[W]e think it is clear,” the court opined, “that any damage to IHOP’s reputation is much less severe than the more immediate injury of cutting off A&F’s reorganization efforts entirely.”70 This opinion was reached despite the court’s recognition that “trademark violations are irreparable” and despite IHOP’s description of the “roaches, moldy produce, improperly refrigerated and prepared food, and other serious issues,” including the city-enforced shutdown of two restaurants “over a forged license issue” at the debtors’ locations.71

Although the Seventh Circuit ultimately did not have to decide which time limit should apply to integrated or interrelated franchise and lease agreements, the handful of lower court opinions addressing the issue are divided.72

VI. Lessons Learned and Questions Remaining

Jurisprudence concerning the effect of a franchisee’s bankruptcy vis-à-vis control of real property at a franchised location is unsettled, and potentially quite unsettling, both for the franchisor and franchisee.

Karfakis teaches that an insolvent franchisee may be able to revive a terminated franchise agreement by filing for bankruptcy protection prior to being physically evicted from the franchised location, thereby reclaiming for the

67. Id.
68. Id. at 766.
69. Id. at 768–70.
70. Id. at 770.
bankruptcy estate what may be the debtor’s most valuable asset. *A&F Enterprises* and *FPSDA* instruct that franchisees that proceed as though their interrelated lease and franchise agreements can be assumed at any time prior to plan confirmation may or may not be correct, and do so at their own peril.

The divergence of opinion between the decisions in *A&F Enterprises* and *FPSDA* suggests another potential ramification of the interplay between the Bankruptcy Code’s subtly conflicting treatment of executory contracts and nonresidential leases, i.e., whether an incurable non-monetary default would preclude a debtor/franchisee from assuming a franchise agreement if that agreement were found to be indivisible with a nonresidential lease containing default provisions similar to those contained in the franchise agreement.

Under Section 365(b)(1)(A), a debtor cannot assume an executory contract unless all defaults—monetary and non-monetary—are cured. Thus, for example, if a franchisee’s financial difficulties forced it to cease operations prior to filing for bankruptcy protection, in violation of a continuous operation clause in the franchise agreement, the franchisor could preclude the debtor from assuming the franchise agreement.74

But a debtor can assume a nonresidential lease notwithstanding the failure to cure a non-monetary default, if such default is incapable of being cured. The natural question, then, is this: if an interrelated lease and franchise agreement each contain a continuous operation clause and the franchisee closes shop before filing for bankruptcy protection (an “historical” default incapable of being cured), can the debtor assume the agreements or not? The answer to that question will depend, of course, on the jurisdiction and the unique facts of the case. If a court confronted with the issue is persuaded by the reasoning and policy considerations underlying the decisions in *Karfakis* and *A&F Enterprises*, and the franchise agreement and lease at issue are found to comprise a single, indivisible contract, it is not difficult to conceive of a ruling permitting a franchisee/debtor to assume franchise agreement in the face of an historical, incurable default. Such a result would be consistent with practical considerations of bankruptcy policy and Congress’s overarching purposes in the Bankruptcy Code, namely, “the successful rehabilitation of the business for the benefit of both the debtor and all its creditors.”78

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74. See, e.g., *In re Lee West Enters., Inc.*, 179 B.R. 204 (Bankr. C.D. Cal. 1995); *In re Claremont Acquisition Corp. Inc.*, 113 F.3d 1029 (9th Cir. 1997).
77. Whether it is possible to craft a lease and franchise agreement to avoid being deemed—in every jurisdiction and factual scenario—as a single, indivisible contract is beyond the scope of this article. It seems unlikely, however, given the reasoning of the cases discussed here.
78. *In re BankVest Capital Corp.*, 360 F.3d 291, 299–300 (1st Cir. 2004).
Turning an (Occasional) Blind Eye: Selective Enforcement of Franchisee Post-Term Non-Compete Covenants

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Post-term non-compete covenants barring former franchisees from operating competing businesses are common in franchise agreements. As discussed in prior Franchise Law Journal articles, such restrictive covenants are enforceable in many circumstances.¹ Just because a franchisor can seek to enforce its post-term covenants not to compete against former franchisees that are operating competing businesses, does that mean a franchisor must do so? Like any business, franchisors prefer the flexibility to decide which legal claims to pursue, including whether to prosecute post-term non-compete actions against specific former franchisees. However, a franchisor’s failure to consistently enforce its non-compete covenants could jeopardize future enforcement efforts.

This article explores a franchisor’s obligation, if any, to enforce non-compete covenants against former franchisees and the implications of selective enforcement of such covenants. Part I summarizes the general law regarding the enforceability of covenants not to compete in franchise agreements.

Part II analyzes whether a franchisor has an obligation to enforce its post-term non-competes against former franchisees that open competing businesses. Absent contractual language requiring a franchisor to take action to protect the system from competition, a franchisor generally cannot be compelled to sue former franchises for non-compete violations.

Part III addresses the implications and risks of a franchisor’s selective enforcement of its post-term covenants not to compete against former franchisees. The general takeaway is that, as long as a franchisor can rationally explain its prior non-enforcement decisions, past selective enforcement will not bar future enforcement efforts. However, depending on the circumstances, inconsistent enforcement can give rise to arguments by a former franchisee that the non-compete covenant does not serve a legitimate business purpose or is not reasonable, that the franchisor waived the covenant or should be estopped from enforcement, that enforcement would be impermissibly discriminatory, or that the franchisor will not be irreparably harmed by the competition.

I. Background: Non-Compete Covenants in Franchise Agreements

A. General Standard

The interpretation and enforcement of a non-compete clause in a contract is controlled by state law. As such, practitioners should review the governing state statutory or common law to determine whether a non-compete covenant is enforceable. A handful of states generally refuse to enforce covenants not to compete, but most states will enforce “reasonable” restrictive covenants. Although a fifty-state survey is beyond the scope of this article, a few generalizations can be made about state laws regulating non-competes. To be valid, a non-compete must be intended to promote a legitimate business interest separate and apart from restraining ordinary, fair competition. To be valid, a non-compete must be intended to promote a legitimate business interest separate and apart from restraining ordinary, fair competition. In addition, the scope of the non-compete must be reasonable in duration and geography. Courts have held reasonable post-term durations ranging from six months to five years and geographic restrictions of up to 100 miles. In some

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2. In re Se. Banking Corp., 156 F.3d 1114, 1121 (11th Cir. 1998).
4. See, e.g., Novus Franchising, Inc. v. Livengood, No. 11-1651 (MJD/TNL), 2012 WL 38580, at *7 (D. Minn. Jan. 9, 2012) (“The rationale for enforcing a non-competition covenant is based on the freedom of contract. However, it is well settled that only a legitimate business interest may be protected by a non-competition covenant. If the sole purpose is to avoid ordinary competition, it is unreasonable and unenforceable.”) (internal citation and quotations omitted); Vantage Tech., LLC v. Cross, 17 S.W.3d 637, 644 (Tenn. Ct. App. 1999) (to serve a “legitimate business interest,” a non-compete clause must protect some interest “over and above ordinary competition” such that, without the non-compete, “an unfair advantage in future competition” would arise).
5. See, e.g., Singas Famous Pizza Brands Corp. v. New York Advertising LLC, 468 F. App’x 43, 46–47 (2d Cir. 2012) (holding that a ten-mile geographic scope of a franchise agreement’s post-termination non-compete clause was reasonably calculated toward furthering franchisor’s legitimate interests in protecting its knowledge and reputation as well as its customer goodwill).
instances, courts may have the authority to modify (or blue pencil) non-compete covenants that are overbroad.8

B. Legitimate Business Purposes

Courts have recognized several legitimate business purposes that can justify a covenant not to compete in the franchise context. These include the following: (1) protecting a franchisor’s trade secrets and proprietary information, (2) preserving goodwill and avoiding customer confusion, (3) refranchising, and (4) sending a message to the system and discouraging “breakaway” franchisees.

1. Protecting Franchisor’s Trade Secrets and Confidential Information

Franchising is not simply the distribution of goods and services; it is the conveyance of valuable knowledge. Franchisors typically invest substantial time, money, and effort developing an operational system that is proven to be successful and replicable. By design, this information is not readily available to the public. Many franchisees lack the experience and expertise to “go it alone,” and indeed this is one reason a franchisee may be attracted to the franchise concept in the first place. On the other hand, franchisors would not be willing to turn over their secrets and proprietary methods to a new franchisee if the franchisee, after receiving the franchisor’s confidential information and learning the business, could take down the franchisor’s marks and open a competing business. Thus, franchisors must be able to safeguard their trade secrets and confidential and proprietary systems beyond the term of the franchise agreement. The post-term non-compete covenant is intended to vindicate these legitimate business interests and protect the franchisor (and the system) against unfair competition.9

2. Preserving Goodwill and Avoiding Customer Confusion

Another legitimate business interest that justifies enforcing a non-compete restriction is protecting the system’s goodwill and avoiding customer confusion after the expiration or termination of the franchise agreement. When the franchise term ends, the franchisor usually desires to preserve the value of the goodwill that has attached to the location. If a former franchisee converts to a competing brand, the result is likely to diminish the system’s goodwill in the market.10 Indeed, some courts have analogized the issuance of a franchise to the sale of a business, where the franchisor conveys the benefit

8. See, e.g., FLA. STAT. § 542.335(1)(c).
10. See, e.g., Bad Ass Coffee Co. of Haw. v. JH Nterprises, LLC, 636 F. Supp. 2d 1237, 1249 (D. Utah 2009) (“Defendants’ overnight switch to Java Cove may send the message to potential customers that [the franchisor] endorses Java Cove, or that the Defendants no longer stand by [the franchisor]. Such messages are likely to erode [the franchisor’s] goodwill in the marketplace.”).
of the system’s goodwill to the franchisee during the existence of the franchise. After the expiration or termination of the franchise agreement, the franchisor has an interest in preserving its goodwill in the market. As the U.S. District Court for the District of New Jersey explained in *Jiffy Lube International, Inc. v. Weiss Brothers, Inc.*:

One can view a franchise agreement, in part, as a conveyance of the franchisor’s good will to the franchisee for the length of the franchise. When the franchise terminates, the good will is, metaphysically, reconveyed to the franchisor. A restrictive covenant, reasonably crafted, is necessary to protect the good will after that reconveyance.\(^{11}\)

Under this argument, the non-compete protects the franchisor’s right to exploit the full value of the franchise’s goodwill.\(^{12}\)

Similarly, because a franchisee is the face of the franchise system in the relevant market, customers can become confused when a former franchisee suddenly begins offering similar products or services under a different name. As a result, some courts have recognized avoiding customer confusion as a reasonable justification for post-term covenants not to compete.\(^{13}\)

3. Refranchising

Closely related to the franchisor’s need to preserve goodwill is its desire to “refranchise” in certain territories. An argument can be made that the franchisor, having built goodwill in an area, should be entitled to continue benefiting from such goodwill through a new franchisee in the market. In those instances, a prospective franchisee may be unwilling to enter an existing market and compete against the system’s former franchisee.\(^{14}\) The non-compete covenant therefore protects the franchisor’s legitimate business interest in refranchising.

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\(^{11}\) 834 F. Supp. 683, 691 (D.N.J. 1993); see also Keller Corp. v. Kelley, 187 P.3d 1133, 1138 (Colo. Ct. App. 2008) (“[O]nce the franchised term ends, the franchisor may well possess an interest worthy of protection in not having the former franchisee use the knowledge, training, and experience gained from the franchisor to compete against it. . . . [T]he covenant not to compete protects the goodwill of the business.”).

\(^{12}\) *Jiffy Lube Int’l*, 834 F. Supp. at 692 (“[T]he purpose of the restrictive covenant in this setting is to protect the goodwill of the franchisor.”).

\(^{13}\) See, e.g., Quizno’s Corp. v. Kampendahl, No. 01 C 6433, 2002 WL 1012997, at *7 (N.D. Ill. May 20, 2002) (granting a franchisor an injunction against a former franchisee and finding “enforcement of the non-compete covenant is essential to allow time for the public to stop associating [the competing business] with Quizno’s”); but see 7-Eleven v. Grewal, 60 F. Supp. 3d 272, 283 (D. Mass. 2014) (declining to award injunction enforcing non-compete covenant when “[c]ustomers would have no reason to associate Defendants’ convenience store with the 7-Eleven brand after 7-Eleven’s marks are removed from the premises”).

\(^{14}\) See Bad Ass Coffee, 636 F. Supp. 2d at 1249 (crediting the franchisor’s testimony that a prospective franchisee had shown interest in opening another franchise in the same city, but would not do so if the former franchisee was allowed to operate a competing business); see also Naturalawn of Am., Inc. v. West Grp., LLC, 484 F. Supp. 2d 392, 402 (D. Md. 2007) (holding that it is “perfectly obvious” that the franchisor will be permanently damaged and shut out of the market where its former franchisee operates a competing business).
4. Discouraging “Breakaway” Franchisees

Franchisees are frequently aware of the status of other franchises in the system. Allowing a former franchisee to violate its contractual obligation not to operate a competing business could send the wrong message to the system, suggesting that the franchisor lacks the resources or wherewithal to enforce the non-compete. In turn, this may encourage other franchisees to follow suit by leaving the system and operating competing business. Thus, enforcement of the non-compete discourages “breakaway” franchisees and protect the integrity of the entire system.15

C. Remedies to Enforce Non-Compete Covenants

The most common way for a franchisor to seek to enforce a post-term covenant not to compete is through an injunction.16 If granted, an injunction bars the former franchisee from continuing to operate a competing business within the proscribed geographic area until the expiration of the restricted period. In addition to stopping the unfair competition, injunctions to enforce a non-compete are often preferable to damages actions because the harm to the brand from such competition, including loss of goodwill, is difficult to calculate.17

Alternatively, monetary damages may be available in certain non-compete cases where the franchisor’s loss from the non-compete violation can be reasonably estimated.18 Because an injury will not be deemed “irreparable” if it can be compensated, injunctive relief is not available if monetary damages can be calculated.19

15. Bad Ass Coffee, 636 F. Supp. 2d at 1249 (noting that a franchisor representative “testified that his franchisees are a close-knit community, and that he believes they are keeping a close eye on what happens here. If the non-compete clauses at issue are not upheld in this case, it would be reasonable to think that other [of the franchisor’s] franchisees might be emboldened to follow in Defendants’ footsteps.”).

16. “A party seeking a preliminary injunction generally must show the following: (1) that it has suffered an irreparable injury; (2) that remedies available at law, such as monetary damages, are inadequate to compensate for that injury; (3) that, considering the balance of hardships between the plaintiff and defendant, a remedy in equity is warranted; and (4) that the public interest would not be disserved by a permanent injunction.” eBay Inc. v. MercExchange, LLC, 547 U.S. 388, 391 (2006). “In deciding whether a permanent injunction should be issued, the court must determine if the plaintiff has actually succeeded on the merits (i.e., met its burden of proof).” Ciba–Geigy Corp. v. Bolar Pharm. Co., Inc., 747 F.2d 844, 850 (3d Cir. 1984).

17. Bad Ass Coffee, 636 F. Supp. 2d at 1249–50. “A plaintiff satisfies the irreparable harm requirement by demonstrating ‘a significant risk that he or she will experience harm that cannot be compensated after the fact by monetary damages.’ ” RoDa Drilling Co. v. Siegel, 552 F.3d 1203, 1210 (10th Cir. 2009) (citations omitted).


19. Id. (because monetary damages were available, injury was not irreparable and thus injunction was not available); see also 7-Eleven v. Grewal, 60 F. Supp. 3d 272, 283 (D. Mass. 2014) (declining to award preliminary injunction for the violation of a non-compete covenant, when the franchisee had debranded and when “a denial would not render it impracticably difficult to calculate 7-Eleven’s damages at a subsequent adjudication on the merits”).
II. Current Franchisees Cannot Force a Franchisor to Enforce Non-Competes

As discussed earlier, reasonable covenants not to compete are enforceable in most states. Does the fact that a franchisor can seek to enforce its post-term covenants not to compete against former franchisees mean the franchisor must do so? That is, does a franchisor have an obligation to protect its current franchisees from competition by former franchisees? Generally speaking, the answer is no. Unless the franchise agreement explicitly imposes an affirmative obligation on a franchisor to take certain steps to protect the system, franchisees typically lack the ability to force the franchisor to take action against other current or former franchisees.20

Case law provides examples of the general rule. In Canha v. LaRoche,21 the franchisee owned a Gymboree franchise, which was in the business of providing programs and equipment for child development. She claimed the value of her franchise had been diminished when the franchisor refused to enforce a non-compete covenant against another franchisee, Jane LaRoche, and her former employee and sister-in-law, Maureen LaRoche.22 The plaintiff alleged that the LaRoches had established a competitive business, notwithstanding the fact that both had entered into a non-compete agreement with the franchisor.23 The plaintiff filed suit against the franchisor and both LaRoches, arguing that she was a third-party beneficiary under the non-competition agreement executed between the LaRoches and the franchisor.24 The franchise agreement specifically provided that “Franchisee shall have no right to enforce the obligations of any other franchisees of Gymboree. Franchisee shall not be deemed a third-party beneficiary with respect to any other franchise agreement or other agreement or have any rights to enforce any obligations thereunder.”25 Relying on that language, the Massachusetts Superior Court dismissed the plaintiff’s claims, noting that the franchisor “did not intend for plaintiff to have a stake in actions on the part of [the franchisor] against any other party.”26

In Shoney’s, Inc. v. Morris,27 the franchisee claimed the franchisor had breached its franchise agreements by “permitting the decline of the value and reputation of its trade name . . . causing a reduction in sales at both com-

22. Id.
23. Id.
24. Id. at *3.
25. Id. at *4.
26. Id.; cf. Manpower, Inc. v. Olsteen Permanent Agency, 309 So. 2d 57, 58 (Fla. Dist. Ct. App. 1975) (ruling that the Florida statute on covenants against competition, FLA. STAT. § 542.12, could not be construed to permit a third-party beneficiary to enforce someone else’s noncompetition covenant).
27. 100 F. Supp. 2d 769 (M.D. Tenn. 1999).
pany-owned and franchisee-operated stores.” The franchisee argued that the franchisor had a specific contractual obligation to enforce its brand standards at its own company-owned restaurants. The U.S. District Court for the Middle District of Tennessee disagreed, finding that the franchisor had no implied obligation to maintain a “high level of reputation” among its company-owned stores. The court specifically noted that the language of the franchise agreement required franchisees to maintain system standards without creating a concomitant right to enforce those standards against the franchisor.

The U.S. District Court for the Northern District of Alabama reached a similar result in *Creel Enterprises, Ltd. v. Mr. Gatti’s, Inc.* The case dealt with a plaintiff-franchisee who owned two Mr. Gatti’s pizza restaurants in Birmingham. Another franchisee, B.S.D., owned five Mr. Gatti’s restaurants. After all of B.S.D’s restaurants were shuttered, the plaintiff argued that the franchisor had failed to enforce its quality standards, and that the loss of units in the market had damaged the plaintiff’s locations. The court rejected the franchisee’s claim, finding that “Plaintiffs have failed to point to any provision in their franchise agreements which obligates Mr. Gatti’s to enforce the quality standards provisions in the contracts signed by another franchisee.”

More broadly, courts are resistant to efforts by franchisees to require a franchisor to protect and update the system. For example, in *CMS Enterprise Group v. Ben & Jerry’s Homemade, Inc.*, the franchisee claimed the franchisor had failed to establish sufficient “business methods” to deal with changes in competitive market conditions, including the sale of ice cream pints from convenience stores and supermarkets. In the franchisee’s view, because a franchisor develops and licenses its business methods, it has a generalized duty to constantly refine those methods to protect the system against perceived internal and external threats. Concluding that the franchisor’s general right under the franchise agreement to amend business methods “from time to time” did not “impose an obligation on Defendant to anticipate specific prob-

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28. *Id.* at 775 (internal quotations and citation omitted).
29. *Id.*
30. *Id.*
31. *Id.* Although *Shoney’s* was seemingly limited to the franchisor’s obligation to maintain its own company stores, the same court later clarified that *Shoney’s* has no similar obligation with respect to franchisees. See *Kinnard v. Shoney’s, Inc.*, 100 F. Supp. 2d 781, 794 (M.D. Tenn. 2000) (neither the requirement that the franchisees follow the system nor the franchisor’s right to inspect the franchisee’s restaurants “create an obligation on the part of Shoney’s to maintain its restaurants according to certain standards or to ensure that the other franchisees are maintained according to such standards”).
33. *Id.*
lems facing franchisees or to develop new business methods designed to address those problems,” the court declined to impose such a requirement.35

Although the previously discussed decisions suggest that courts will not impose on franchisors an implied duty to enforce system standards or otherwise “protect” the system, courts are willing to enforce such a duty if it is expressly stated in the parties’ contract. In *The Jade Group, Inc. v. Cottman Transmission Centers, LLC*, each of the relevant license agreements imposed on the franchisor, Cottman, a contractual obligation to “continue to develop, promote and protect the good will and reputation associated with the Cottman name and marks and other distinguishing aspects of the SYSTEM.”36 Certain franchisees claimed Cottman had breached this obligation when it acquired another related brand, AAMCO, and shifted resources from Cottman to AAMCO.37 According to the plaintiff, this resulted in a substantial reduction in the total number of Cottman units, in addition to a loss of critical infrastructure and support.38

Cottman moved to dismiss, arguing that the plaintiffs had no legitimate basis to expect that the number of Cottman units would increase in perpetuity.39 Although agreeing with Cottman that goodwill was not necessarily tied to the number of units, the U.S. District Court for the Eastern District of Pennsylvania nevertheless denied the motion to dismiss, finding that the plaintiff stated a claim under the specific language of the contract.40 In the court’s view, the franchisee had sufficiently alleged that the franchisor had failed to “develop, grow and protect the brand” as required by the license agreement.41

*The Jade Group* is unusual in that the relevant agreements included language that explicitly required the franchisor to “continue to develop, promote and protect the good will and reputation associated with the Cottman names and marks.”42 While this language might seem vague and aspirational, it was enough to lead the court to deny the franchisor’s motion to dismiss. Ultimately, *The Jade Group* confirms the central importance of the language in the underlying agreement. Although U.S. courts will not impose upon a franchisor an implied duty to protect the system from competitors where the franchisor did not expressly agree to undertake such obligations, courts will hold a franchisor to the terms of its agreements.43

35. Id. at *3.
37. Id.
38. Id.
39. Id. at *7.
40. Id.
41. Id. (citing Newark Morning Ledger Co. v. United States, 507 U.S. 546, 555–56 (1993) (describing “goodwill” as “the expectancy of continued patronage”)).
43. Although this article is focused on U.S. cases, other jurisdictions have imposed an implied duty on the part of the franchisor to protect and enhance the brand in the face of competition. See Dunkin’ Brands Canada Ltd. v Bertico Inc., [2015] QCCA 624.
III. Impact of Franchisor’s Selective Enforcement of Non-Competes

Even if a franchisor does not have a contractual or legal obligation to enforce its post-termination covenants not to compete against all former franchisees, failure to do so—that is, selective or inconsistent enforcement—could impact the franchisor’s ability to enforce its restrictive covenants when it wants to. Faced with a franchisor’s lawsuit to enforce a post-termination restrictive covenant, the former franchisee seeking to compete may argue that past inconsistent enforcement by the franchisor: (1) shows the franchisor waived or is equitably estopped from enforcing the restrictive covenant, (2) undermines the franchisor’s claimed justification for the non-compete, (3) violates anti-discrimination provisions in state franchise relationship laws, or (4) shows an injunction is not necessary because the franchisor is not being irreparably harmed by the ongoing competition. Although courts are resistant to such arguments against non-competes, the relevant precedent shows that a franchisor must be prepared to explain any prior selective enforcement of its post-term covenant not to compete.

A. Selective Enforcement Defenses of Waiver and Equitable Estoppel Face Uphill Battle

Faced with an action to enforce a post-term non-compete, former franchisees often argue that a franchisor’s past inconsistent or selective enforcement of the covenant against other former franchisees should bar the franchisor’s current efforts. Such arguments often take the form of the affirmative defenses of waiver or equitable estoppel.

Courts generally are resistant to selective enforcement defenses—“but he did it too”—where a party breached or is breaching its contractual obligations. Selective enforcement defenses often arise in franchise wrongful termination actions. For example, in Original Great American Chocolate Chip Cookie Co. v. River Valley Cookies, Ltd., a former franchisee that was terminated for underreporting gross sales, among other defaults, challenged its termination by arguing that the franchisor had not terminated other franchisees for similar breaches. The Seventh Circuit rejected the defense, holding that a franchisor’s treatment of its other franchisees was irrelevant to the propriety of the termination. As Judge Posner concluded, “[t]he fact that the [franchi-
sor] may, as the [franchisees] argue, have treated other franchisees more leniently is no more a defense to a breach of contract than laxity in enforcing the speed limit is a defense to a speeding ticket.48

Similarly, in Deutchland Enterprises, Ltd. v. Burger King Corp.,49 the Seventh Circuit affirmed the termination of franchisees for violating the franchise agreement’s in-term covenant not to compete. The franchisees argued the termination was not valid because the franchisor had not enforced the franchise agreement’s in-term non-compete against two other franchisees. The court rejected the franchisees’ selective enforcement defense, finding that they were not “similarly situated” to the other franchisees, both of which were corporate multi-unit franchisees engaged in large-scale hospitality operations.50 Such differences justified the franchisor’s business rationale for enforcing the non-compete in some circumstances but not others.

Under precedents such as Original Great American Chocolate Chip Cookie and Deutchland Enterprises, a franchisor’s failure to enforce the franchise agreement’s contractual provisions (including the non-compete provision) against other franchisees does not render the provision unenforceable against the defendant or excuse the defendant’s contractual violation. Without more, the fact that a franchisor waived certain obligations as to some current or former franchisees does not mean it waived the obligations as to all franchisees.51

Given the few franchise cases analyzing selective enforcement defenses, it is useful to examine non-franchise non-compete cases. Outside of the franchise context, several courts have rejected waiver or equitable estoppel arguments that a company’s prior selective enforcement precludes current efforts to enforce a post-termination non-compete against a former employee. Therefore, many courts recognize that a business should be entitled to make a case-by-case assessment of whether to enforce a non-compete. For example, in Minnesota Mining & Manufacturing Co. v. Kirkevold,52 plaintiff 3M moved for a preliminary injunction to enforce a non-compete against its former employee. The former employee argued that 3M had waived its contractual rights and should be estopped for equitable reasons from enforcing the restrictive covenant based on 3M’s failure to enforce such restrictive

49. 957 F.2d 449 (7th Cir. 1992).
50. Id. at 453. The court implied that a franchisor may have a reasonable basis to allow sophisticated franchisees to own competitive businesses, as, for example, when a hotel chain owns multiple restaurant concepts.
51. See Mr. Steak, Inc. v. Bellevue Steak, Inc., 555 P.2d 179, 182 (Colo. Ct. App. 1976) (holding that the franchisor’s “actions with regard to other franchisees cannot sustain a finding that it waived its rights under the specific terms of its agreement with these defendants”).
52. 87 F.R.D. 324 (D. Minn. 1980).
covenants against other former employees who possessed knowledge of 3M’s confidential information. The U.S. District Court for the District of Minnesota rejected the employee’s argument that 3M’s failure to enforce the non-compete against others constituted an estoppel or waiver. The court found there were many differences between the defendant and the other employees, which factored into the employer’s decision not to seek to enforce the other restrictive covenants. Prior non-enforcement against others, the court stated, was “not overly probative of any intent to relinquish its contractual rights or to knowingly mislead so as to estop” enforcement of the covenant.53 The court went on to conclude that “to hold otherwise would effectively place employers in the precarious position of being compelled to enforce all such restrictive covenants with respect to all its former employees, which might encourage attempts to restrain trade, and which might undermine labor relations.”54

A similar holding was reached in Laidlaw, Inc. v. Student Transportation of America, Inc.55 where a group of former executives resigned from Laidlaw and then formed their own competing transportation company. In response to Laidlaw’s preliminary injunction motion, the executives argued that the non-compete was not enforceable because Laidlaw had failed to consistently enforce similar non-compete agreements with other former employees. The U.S. District Court for the District of New Jersey rejected the selective enforcement defenses, finding “Laidlaw’s actions (or lack thereof) in other instances do not amount to a waiver or estoppel of its contract rights.”56 The court concluded that requiring an employer to enforce every restrictive covenant, without regard to cost-effectiveness or individual circumstances, was “impractical and unfair, not only to [the plaintiff company] but to other former employees.”57 “Whether a restrictive covenant may be enforced depends on its reasonableness under the particular circumstances. Plaintiffs may or may not seek to enforce other covenants, but the primary inquiry is whether enforcement of the covenant in this case is reasonable.”58 Any other conclusion, the court reasoned, would require every employer to enforce its restrictive covenants against every departing employee, without consideration of expense, need, or the particular circumstance of each individual situation.59

On the other hand, some courts have recognized waiver or equitable estoppel defenses where a party inconsistently enforces its non-competes. For example, in Surgidev Corp. v. Eye Technology, Inc.,60 the U.S. District Court for the District of Minnesota refused to enjoin four former officers

53. Id. at 336.
54. Id.
56. Id. at 751. The court nevertheless denied the requested injunction for other reasons. Id. at 767–69.
57. Id. at 751.
58. Id. (emphasis in original).
59. Id.
who set up a competing company because the plaintiff company had permitted at least twenty-eight other former employees, including high-ranking executives, to leave and join competitors. The court accepted the defendants’ waiver and equitable estoppel defenses, finding that “it would be inequitable to permit plaintiff to now rely on a non-compete agreement which it has so blithely ignored in the past.” Notably, the magnitude of the past non-enforcement was critical to the court’s holding.

Even where a court is receptive to a potential waiver defense, the party claiming waiver of a non-compete bears a heavy burden of proof. Waiver and estoppel are the exception, not the rule. A former employee (or franchisee) generally must demonstrate that the company’s prior failures to enforce its restrictive covenants against others amount to a “complete disregard for those provisions.” Most courts will not find a complete disregard that supports a finding of waiver as long as the franchisor or employer can offer a reasonable explanation for prior decisions not to enforce its post-term non-compete covenant against others. That is, most courts reject the notion that employers automatically waive the right to enforce restrictive covenants by suing only some employees, noting a company has the right to exercise its business judgment as to whether any prohibited competition was likely enough to warrant legal action.

Finally, some courts have indicated at least a willingness to consider a franchisee’s selective enforcement defenses in franchisee non-compete cases. For example, by expressly noting that the defendant-franchisees “have failed to offer sufficient documentation to support this [selective enforcement] de-

61. Id. at 698. See also Midwest Television, Inc. v. Oloffson, 699 N.E.2d 230, 237 (Ill. App. Ct. 1998) (adopting Surgidev waiver standard and holding that question of fact existed as to whether defendant employer waived the non-compete provision by selective enforcement).

62. Kempner Mobile Elecs., Inc. v. Sw. Bell Mobile Sys., LLC, No. 02-C-5403, 2003 WL 1057929, at *26 (N.D. Ill. Mar. 10, 2003) (citing Surgidev for the proposition that the former employee must show the employer’s conduct evinced a “complete disregard” for its restrictive covenants to establish a waiver; the court found the evidence did not satisfy the “complete disregard” standard).

63. See, e.g., Horne v. Radiological Health Servs., PC, 371 N.Y.S.2d 948, 959-61 (N.Y. Sup. Ct. 1975), aff’d, 379 N.Y.S.2d 374 (N.Y. App. Div. 1976) (noting that the selective enforcement defense could exist, but finding that the defendant-employee did not meet its burden to show waiver because, without more, the employer’s lack of uniform enforcement was not enough); see also Thompson v. Allain, 377 S.W.2d 465, 468 (Mo. Ct. App. 1964) (“The fact that some of the plaintiffs did not invoke the covenant as to other retiring partners does not amount to a waiver as to defendant. The partnership, as it existed when previous members retired and located in North Kansas City, may have had good reasons for not having objected to such conduct.”).

64. See, e.g., Ajilon Prof’l Staffing, LLC v. Griffin, No. CV-09-561PHXDGC, 2009 WL 1507559, at *5 n.2 (D. Ariz. May 29, 2009) (“[T]he fact that enforcement decisions are made case-by-case—as would always be the case in any business—does not suggest that the non-compete provision fails to protect legitimate interests. A business may reasonably conclude that a provision protects very legitimate interests, but that the cost of litigation outweighs the threat presented by a particular former employee’s competition.”); Horne, 371 N.Y.S.2d at 959–61 (in concluding the defendant-employee had not proved the company intended to waive enforcement of its covenants, the court reasoned that the company’s dealings with each particular employee had individual facts that affected the company’s business judgment).
fense,” the U.S. District Court for the Middle District of Florida in Medi-Weightloss Franchising USA v. Las Colinas Media Weightloss Clinics LLC suggested that selective enforcement defenses to non-compete violations are available to franchisees, although the evidentiary burden is high.65 Where available, a franchisee’s defense to a non-compete based on the franchisor’s alleged inconsistent enforcement is fact specific. It will depend largely on the number of the past instances where the franchisor failed to enforce the post-termination covenant not to compete, how recent those instances were, and the similarities between those former franchisees (and their markets) and the franchisee at issue.

B. Inconsistent Enforcement May Undermine Claimed Justification or Show the Covenant Is Not Reasonable

Separate from the affirmative defenses of waiver and equitable estoppel, inconsistent enforcement of a non-compete may jeopardize a franchisor’s ability to establish that the non-compete is reasonable and necessary. As noted earlier, in assessing the enforceability of a non-compete, courts generally ask whether the restriction is reasonably necessary to protect the company’s legitimate business interests. Also, courts require post-term covenants not to compete to be narrowly tailored so that they limit competition only to the extent necessary to protect the legitimate business interests of the franchisor.

Some courts may scrutinize a franchisor’s asserted rationale for seeking to enforce its non-compete in light of its prior failures to enforce the non-compete against other former franchisees. In certain cases, a franchisor’s past non-enforcement may undermine its claimed justification for enforcing the current non-compete; that is, the franchisor may not be able to establish the non-compete is valid and enforceable.

Faced with a post-termination non-compete, a former franchisee could argue that a franchisor’s selective enforcement against other former franchisees shows that a covenant is not reasonably necessary to protect the franchisor’s claimed interest. Under such an argument, the fact that the franchisor has not enforced its non-compete agreements against certain other former franchisees that opened competing businesses would allegedly show that the franchisor either does not have a protectable interest or the non-compete is broader than necessary to protect such interest.

For example, as discussed earlier, several courts have held that protection of a franchisor’s trade secrets and confidential information is a legitimate interest that can support enforcement of a post-termination covenant not to compete. However, the argument for protecting a franchisor’s purported trade secrets—indeed, the argument for the very existence of trade secrets—appears much less compelling where a franchisor knowingly allows other former franchisees that possessed the franchisor’s trade secrets to compete against the franchisor.

without action. Failure to protect the confidentiality of trade secrets can result in loss of protection for such purported trade secrets. Further, a former franchisee may argue that if a post-term non-compete were really necessary to protect the franchisor’s trade secrets, the franchisor would have enforced the non-compete against all former franchisees that launched competing businesses. Accordingly, where a franchisor argues that enforcement of a post-term non-compete is justified by the legitimate business need to protect the franchisor’s trade secrets and confidential information, inconsistent enforcement of the restrictive covenant against other former franchisees risks arguments that (1) the information is no longer secret and therefore not a protectable “trade secret” that justifies a restrictive covenant, and/or (2) the franchisor suffers no real harm from non-enforcement.

In addition, franchisors frequently argue that their interest in refraenchising the relevant territory supports enforcement of a particular post-term covenant not to compete. In such cases, the franchisor’s market-by-market strategy becomes critical evidence supporting the enforceability of a particular non-compete. For example, in Petland, Inc. v. Hendrix, a franchisor (Petland) sought a preliminary injunction to bar its former franchisee (Hendrix) from continuing to operate a competing pet store at the site of its terminated franchise location in Stafford, Texas. In response to the franchisor’s argument that enforcement of the non-compete was necessary to protect the franchisor’s interest in refraenchising the Stafford market, Hendrix demonstrated that Petland had permitted three other former franchisees to remain in the pet store business following the termination of their franchise agreements. The U.S. District Court for the Southern District of Ohio was receptive to the franchisee’s arguments, but ultimately granted the injunction after finding the franchisor could justify its decision to enforce the post-term non-compete in some cases but not others, stating: “That these former franchisees paid a monetary settlement to Petland supports [Hendrix’s] position and . . . this fact might even prove dispositive if the circumstances of the instant case were not inescapably distinguishable.” Specifically, the court found that “the company had no intention of refraenchising those select markets,” while “Petland claims an interest in refraenchising the Stafford market.” The court went on to conclude that “[a]ny selective enforcement of the clause here is grounded in credible business reasons and does not serve to render the non-competition clause invalid against [Hendrix].”

68. Id. at *7.
69. Id.
70. Id.
The court in *Petland* concluded that the franchisor’s ability to offer credible business reasons for its selective enforcement distinguished it from cases like *Patel v. Baskin-Robbins, USA Co.*,71 where the court denied an injunction because the franchisor failed to present persuasive evidence for its inconsistent enforcement of its non-compete clause. The lesson is that courts will scrutinize a franchisor’s rationale for past selective enforcement in assessing whether the franchisor has shown the non-compete is enforceable.

Further, as noted earlier, most courts require a covenant not to compete to be reasonable in scope of prohibited activity, geography, and duration. Selective enforcement of a non-compete covenant may become evidence as to whether the scope of the non-compete is reasonable. For example, in a non-franchise case involving Estee Lauder, the U.S. District Court for the Southern District of New York enforced a post-termination covenant against a former employee but reduced the covenant’s duration based on Estee Lauder’s treatment of other former employees.72 After the company sought to enforce a one-year non-compete against a former employee, the former employee responded by producing evidence that Estee Lauder routinely negotiated much shorter post-separation restraints (ranging from three to five months) with other departing executives. Indeed, the company had offered to reduce the former employee’s own non-compete to four months. Based on the company’s past actions, the court held that a one-year restriction was unnecessary to protect the company’s interest. The court granted the company’s request for an injunction, but shortened the duration of the non-compete from one year to five months to conform to what was necessary to protect the company’s interests based on the company’s negotiations with other former employees.73

Under such rationale, if a franchisor has allowed other former franchisees to negotiate the terms of the non-compete (e.g., reduced duration, geographic scope, or prohibited practices), a court could find the clause is broader than reasonably necessary to protect the franchisor’s interests and therefore not reasonable as drafted. For this reason, franchisors that enter into settlement agreements with competing former franchisees should consider carefully how they describe the matters, especially if the franchisor agrees to waive or reduce the scope of the non-compete’s restrictions. Moreover, in settling with or otherwise deciding not to litigate against a former franchisee, franchisors should carefully document why they have agreed to forego enforcement of their non-compete rights in case they must subsequently explain such selective enforcement in future litigation.

Accordingly, it is clear that at least some courts will consider evidence of inconsistent enforcement of post-termination restrictive covenants, or settle-

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73. Id. at 181.
ments regarding such covenants, in evaluating whether the covenant is enforceable and reasonable. On the other hand, other courts have concluded that a company’s treatment of other former employees has no bearing on the enforceability of a post-termination covenant not to compete against a different former employee.74

C. Selective Enforcement Under State Anti-Discrimination Laws

Former franchisees located in certain states may also attempt to argue that a franchisor’s selective enforcement of a post-term covenant not to compete violates anti-discrimination provisions in applicable state franchise relationship laws. Seven states have anti-discrimination provisions in their franchise relationship laws or regulations: Arkansas, Hawaii, Illinois, Indiana, Minnesota, Washington, and Wisconsin.75 The particular provisions vary from state to state, but these statutes and regulations generally require franchisors to impose the same charges on their franchisees (e.g., franchise fees, royalties, and costs of goods) and to avoid discriminatory treatment of similarly situated franchisees.76 A franchisor can rebut a claim of discrimination by showing that its treatment was reasonable and based on franchises granted at materially different times.77

Such anti-discrimination provisions, however, do not appear to save a former franchisee that is breaching its post-termination covenant not to compete, even if the franchisor’s past non-compete enforcement has been inconsistent. For example, in Precision Enterprises, Inc. v. Precision Tune, Inc.,78 the U.S. District Court for the Western District of Washington held that a franchisor could sue one franchisee for violation of a non-competition agreement while not pursuing similar violations by other franchisees because such selective enforcement did not constitute illegal discrimination under the Washington Franchise Investment Protection Act.79 Similarly, in the Deutchland Enterprises case mentioned earlier, the Seventh Circuit held the termination of a franchisee for breaching its franchise agreement’s in-term non-compete was not “discriminatory” in violation of the Wisconsin Fair Dealership Law, even though the franchisor did not enforce the non-compete against two

74. See, e.g., GCA Servs. Grp., Inc. v. ParCou, LLC, No. 2:16-cv-02251-STA-cgc, 2016 WL 7192175 (W.D. Tenn. Dec. 12, 2016) (in an employee non-compete case, affirming denial of an employee’s request for discovery regarding its selective enforcement of non-compete defense because such information was irrelevant to whether such agreements are enforceable).

75. ARK CODE ANN. § 4-72-204; HAW. REV. STAT. §§ 482E-6(1)-6(2)(C); 815 ILL. COMP. STAT. 705/18; IND. CODE § 23-2-2.7-2(5); MINN. RULES § 2860.4400, WASH. REV. CODE §§ 19.100.180(2)(c), (2)(j); WIS. STAT. §§ 135.02, 135.03.

76. See, e.g., 815 ILL. COMP. STAT. 705/18.

77. See, e.g., WASH. REV. CODE § 19.100.180(2)(c).


79. Id.; see also Armstrong v. Taco Time Int’l, Inc., 30 Wash. App. 538, 543–44 (1981) (rejecting the franchisee’s argument that selective enforcement of non-compete constituted discrimination in violation of Washington Franchise Investment Protection Act; holding in-term and post-termination covenant not to compete, as modified, was enforceable).
other franchisees, where the franchisee at issue was not similarly situated to those other franchisees.80

Once again, as long as a franchisor can offer reasonable explanations and distinctions for enforcing its non-compete against some former franchisees but not others, state anti-discrimination provisions in franchise relationship laws should not preclude enforcement.

D. Effect of Inconsistent Enforcement on Proving Irreparable Harm

As mentioned earlier, enforcement of non-compete covenants often arises in the context of a franchisor’s motion for a preliminary injunction. To obtain a preliminary injunction, the movant must prove, among other things, that it will suffer “irreparable harm” absent the injunction.81 Even if a franchisor’s inconsistent enforcement of its post-term non-competes does not render them unenforceable or constitute waiver, allowing other former franchisees to compete could jeopardize the franchisor’s ability to establish irreparable harm.

As one commentator has explained in the employment context, “it is fair game for the party opposing the injunction to assume that the employer will not be irreparably injured any more than it was in a similar situation in which it did not seek to enforce the covenant against another departing employee.”82 The same can be argued in the franchise context.

In Baskin-Robbins Inc. v. Patel, the U.S. District Court for the Northern District of Illinois declined to issue a preliminary injunction based on evidence of the franchisor’s selective enforcement of its non-compete.83 After Baskin-Robbins made a business decision to move away from stand-alone ice cream shops in favor of stores offering ice cream, doughnuts, and sandwiches, many former Baskin-Robbins stores converted to a competing brand, KaleidoScoops.84 Although Baskin-Robbins had objected to some of the conversions and sought to enforce its non-compete, in many instances it had chosen not to enforce the covenants.85 In light of the evidence of Baskin-Robbins’ past inconsistent enforcement of the non-compete covenants, the court found that the franchisor had not presented sufficient evidence of irreparable harm and denied the requested injunction.86

80. Deutchland Enter., Ltd. v. Burger King Corp., 957 F.2d 449 (7th Cir. 1992).
82. 4B N.Y. PRACTICE SERIES, COMMERCIAL LITIGATION IN NEW YORK STATE COURTS § 80:34 (4th ed. 2016).
84. Id. at 609.
85. Id.
86. Id. at 610–11. Although the court denied the requested injunction on the papers, it indicated that it would allow additional evidence at any future injunction hearings. In addition, the court acknowledged that the franchisor may have been “influenced by a conclusion that [the defendant] no longer wished to operate a stand-alone store in that location and had no plans to develop a multiple products store there.” Id. at 609.
In *E.B.N. Enterprises, Inc. v. C.L. Creative Images, Inc.*, the franchisor sought a preliminary injunction enforcing a non-compete covenant after the franchisee repudiated the franchise agreement shortly before expiration and continued to operate a hair salon under a new name. The franchisor argued, among other things, that an injunction was appropriate to “protect its franchise system from the perception that it does not enforce its agreements.” But the U.S. District Court for the Northern District of Illinois rejected the franchisor’s argument, noting that the franchisor had not only failed to present any evidence in support of its conclusion, but it had successfully sought to exclude evidence related to other franchisees. In the court’s view, the franchisor’s attempts to prevent discovery regarding its selective enforcement as to other franchisees meant that it “cannot now claim its need for an injunction rests upon other franchisees.”

On the other hand, other courts have concluded that past selective enforcement will not preclude a finding of irreparable harm as long as the franchisor can offer a rational business explanation for why it sought to enforce its post-term non-compete against some former franchisees but not others. For example, in *Bad Ass Coffee Co. of Hawaii v. JH Enterprises, LLC*, the franchisor sought an injunction after the defendants declined to renew their franchise agreement and converted to a competing business in the same location. The former franchisees argued that the franchisor could not show irreparable harm because it had allowed other former franchisees to open competing businesses and because it lacked a “formalized system to monitor whether former franchisees comply with the non-compete agreements.” Although agreeing that “each of these considerations cuts against a finding of irreparable injury,” the U.S. District Court for the District of Utah nevertheless found that the franchisor was free to forego enforcement of its non-compete agreements in specific instances based on its own business judgment, stating that it did “not believe that making compromises necessarily means that [the franchisor] meant to devalue, or has devalued, their non-competition agreements globally.” The court similarly found that the franchisor was under no obligation to “check up” on franchisees whose agreements had expired, noting that it was reasonable to rely on the franchisees’ contractual promise not to compete.

Similarly, in *Petland, Inc. v. Hendrix*, the U.S. District Court for the Southern District of Ohio granted a preliminary injunction to halt a competing business. There, the evidence showed the franchisor had permitted

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88. *Id.* at *5*.
89. *Id.*
91. *Id.* at 1250.
92. *Id.* at 1251.
93. *Id.*
three other former franchisees to remain in the same line of business following the termination of their franchise agreements.\textsuperscript{95} The court found it significant that the franchisor had elected to abandon those select markets, whereas it intended to remain in the market where the injunction had been sought.\textsuperscript{96} \textit{Petland} illustrates why evidence related to a franchisor’s intent to refranchise may be dispositive on the issue of irreparable harm.

As long as a franchisor can offer evidence in an injunction proceeding explaining and justifying any prior inconsistent enforcement of its post-term covenant not to compete, such selective enforcement should not preclude a finding that a former franchisee’s ongoing violation of its post-term non-compete is irreparably harming the franchisor.

\textbf{IV. Conclusion}

Absent contractual language in the franchise agreement requiring a franchisor to take action to protect the system from competition, a franchisor generally cannot be compelled to enforce post-term covenants not to compete against former franchisees. Nevertheless, selective enforcement of restrictive covenants raises various strategic, legal, and business considerations. In many instances, aggressive enforcement reinforces the sanctity of the covenants and promotes system-wide stability. In other cases, a franchisor may have legitimate business reasons to disregard some competition by former franchisees. However, failure to enforce a non-compete covenant consistently can open up a franchisor to arguments that the covenant is not really necessary for its claimed business purpose (such as protection of trade secrets or prevention of customer confusion) or that competition by a former franchisee will not really irreparably harm the franchisor.

A franchisor should therefore carefully assess whether and when to enforce its non-compete covenants against former franchisees. In general, a franchisor’s strategic selective enforcement should not prejudice future enforcement efforts, as long as the franchisor can rationally explain prior non-enforcement decisions.

\textsuperscript{95} Id. at *7.

\textsuperscript{96} Id.
Canada: It’s Like Watching A Car Crash in Slow Motion

Peter Dillon

There are strange things done in the midnight sun
By the men who moil for gold;
The Arctic trails have their secret tales
That would make your blood run cold;
The Northern Lights have seen queer sights,
But the queerest they ever did see
Was that night on the marge of Lake Lebarge
I cremated Sam McGee.

With homage to the writings of Robert Service, this article examines the current mixed and maturing state of the developing franchise jurisprudence in Canada and posits that there are other queer happenings in the land of the midnight sun. Since the inception of franchise-specific legislation in Ontario in 2000, there have been some initial judicial decisions that have led the author to question whether franchising would—or could—survive as a business model in Canada. Some of these early cases, worrisome to the author, continue to stand. Practitioners preparing disclosure documents for use in Canada should be acutely aware of these cases and other issues, especially given the fact that the amount paid by the captive bar insurance company on behalf of Ontario practitioners to settle claims doubled in the period 2002–2006 to 2007–2011. From 2011 to 2013, LawPro has been paying over $2 million annually to settle an average

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1. The author’s initial title for this paper was “Those Awkward Teenage Years: The Slow and Sometimes Painful Process of the Maturation of Franchise Disclosure Laws In Canada.” Recent case law has motivated me to provide a somewhat more stark characterization of the state of the Canadian franchise landscape.
2. ROBERT W. SERVICE, The Cremation of Sam McGee, in SONGS OF A SOURDOUGH (1907).

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of fifteen franchise negligence cases per year. Because this early case law was created by a Court of Appeal, it is of particular concern because it may require legislative amendment to overturn its impact. From time to time, a minor rebalancing of the judicial interpretation of franchise laws provides what the author sees as a more balanced approach in determining the relative rights of franchisors and franchisees. With this regulatory context in mind, this article is intended to provide an overview of the current essentials of franchise disclosure in Canada.

I. Some Significant Differences

Most U.S. attorneys understand that Canada and the United States have a lot in common. We share a common language, the Anglo-Norman common-law tradition, and have more cultural commonalities than differences. Superficially, the franchise laws in place in six Canadian provinces have much in common with the pre-sale disclosure regime established by the FTC Franchise Rule (although, unlike some U.S. state jurisdictions, no Canadian jurisdiction

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5. E-mail from Tim Lemieux, Claims Prevention & Stakeholder Relations Coordinator, Lawyers’ Professional Indemnity Company (LAWPRO) to the author (Feb. 13, 2017, 11:08:24 a.m. EST) (on file with author). In terms of the causes of franchise claims, the breakdown for the past ten years consists of: (i) Communication-related errors: 47% (Examples include: (1) failing to inform a franchisor client about the disclosure requirements under the Arthur Wishart Act and the severe consequences of inadequate disclosure; (2) failing to document in writing that a client instructed the lawyer to take a course of action that was different from the one the lawyer recommended; and (3) retainer did not clearly specify work that was to be done by the lawyer and/or outside expert (e.g., accountant or tax expert)); (ii) Errors of law: 21% (Examples include: (1) failing to provide proper advice to the franchisee with regards to the information disclosed by the franchisor pursuant to the requirements under the Arthur Wishart Act; and (2) failing to be sufficiently aware of the disclosure requirements under the Arthur Wishart Act); (iii) Inadequate investigation: 18% (Examples include: (1) failing to adequately review a disclosure document; (2) failing to do due diligence that might discover encumbrances, liens, or outstanding debts; and (3) overlooking or failing to advise clients properly as to their rights of rescission); (iv) Time and deadline errors (7%) and conflicts of interest (7%). Id.

6. The prospect of legislative amendment is, at least in the short to medium term, unlikely. The regulation of franchising falls within provincial jurisdiction under the Canadian Constitution. This means that, in order to be effective, legislative amendment would need to be coordinated across all six jurisdictions that currently regulate the subject matter. That’s not likely to happen, because most politicians in Canada view franchise legislation as an easy way to make themselves look good by protecting the consumer, as opposed to what the author views as the more balanced approach taken by the FTC in its rulemaking process.

7. Alberta was the first province to introduce franchise specific legislation in 1971. The securities-type franchise law in Alberta was completely gutted and replaced by a presale disclosure law in 1995, at about the same time that Michigan, Wisconsin, and Indiana were also disassembling their registration regimes. See Franchises Act, R.S.A. 2000, c.F–23. Ontario followed with its strangely named Arthur Wishart Act (Franchise Disclosure), 2000 S.O. 2000, c.3. Prince Edward Island, New Brunswick, Manitoba and, most recently, British Columbia, have since followed suit. Franchises Act, S. P. E. I. 2005, c. 36; Franchises Act S.N.B. 2007, c. F–23.5; Franchises Act, C.C.S.M. c. F156; Franchises Act, SBC 2015, c 35. The Ontario Act was initially dubbed Bill 33, The Franchise Disclosure Act, 1999. It was subsequently renamed, as part of a compromise in its drafting stage, for the Minister of Justice and Attorney General who held office in the early 1970s, when a legislative report first recommended franchise legislation for Ontario.

8. 16 C.F.R. § 436 et. seq.
requires registration of the disclosure document). However, there are some major differences in the legislation, and certainly in the judicial interpretation of that legislation, that have created significant practical differences between the two countries. Minor slip-ups north of the forty-ninth parallel can easily result in an otherwise thorough and complete disclosure document being rendered completely non-compliant. Non-compliance in Canada can have considerably more severe repercussions than non-compliance in the United States or other jurisdictions. Here is a potpourri of some of those differences and their repercussions.

A. Expansive Personal Liability

Everything else aside, the prospect that a senior officer or director of a corporate franchisor might lose everything that he or she has amassed over a lifetime of endeavor as the result of a deficient disclosure document should focus a franchisor’s—and its attorney’s—attention on scrupulous compliance with Canadian disclosure requirements. The fact that many instances of personal liability have arisen from noncompliance with formulaic or technical requirements should be even more attention-getting.9

Personal liability arises in all Canadian jurisdictions if a franchisee suffers a loss because of a misrepresentation contained in the disclosure document or in a statement of material change, or as a result of the franchisor’s failure to otherwise comply with its disclosure obligations.10 Parties potentially facing personal liability include the franchisor (if he or she is an individual), the franchisor’s agent, the franchisor’s broker, the franchisor’s associates,11 and every person who signed the disclosure document or statement of material change. Each of the six Canadian statutes requires that two officers or directors of the franchisor sign the disclosure document, certifying that the disclosure document contains no untrue information, representation, or statement, and that it includes every material fact, financial statement, statement, or other information required to be included.12

The notion of certification is nothing new for U.S. practitioners. It exists in all registration jurisdictions, but typically requires only that the individual certify that he or she has read and is aware of the contents of the application and documents, and that “all material facts stated in all those documents are

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10. Arthur Wishart Act (Franchise Disclosure), 2000 S.O. 2000, c.3, s. 7(1); Franchises Act, S. P. E. I. 2005, C. 36, s. 7(1); Franchises Act S.N.B. 2007, c. F–23.5, s. 7(1); Franchises Act, C.C.S.M. c. F156, s. 7(1); Franchises Act, R.S.A. 2000, c.F–23, s. 9(1); Franchises Act, SBC 2015, c 35, s. 7(1).
11. For a discussion as to who may constitute a “franchisor’s associate,” see discussion infra, Section I.G.
12. If the franchisor has only a single officer and director, then only one signature is required.
accurate and those documents do not contain any material omissions.”

An officer or director in the United States is liable only for his or her material involvement in a misrepresentation contained in the document. In Canada, not only is a signatory exposed to unlimited personal liability for a misrepresentation contained in the disclosure document—but he or she is also liable if the disclosure document is found non-compliant “in any way.”

As if the personal liability arising under the misrepresentation provisions of each of Canada’s six franchise statutes were not enough, Canadian courts have followed the Ontario Court of Appeal’s decision in 1490664 Ontario Ltd. v. Dig this Garden Retailers Ltd. and held that the personal liability provisions also apply to an award of damages flowing from a statutory rescission claim. The author suggests that this interpretation is contrary to the clear wording of the statute.

The author believes that the judicial interpretation giving rise to this unlimited personal liability in the context of a rescission claim is rather convoluted. It commences with a statutory rescission claim of the franchisee (Section 6 of the Ontario Franchise Disclosure Act (Ontario Act)), on the basis that the franchisor failed to provide a disclosure document in accordance with its Section 5 obligations. The Section 6 rescission claim results in a claim for an amount of damages calculated in accordance with that subsection, i.e., subsection 6(6). Note that subsection 6(1) specifies that these damages are payable only by the franchisor or the franchisor’s associate, “as the case may be.”

Based on the Dig This decision, courts have permitted Section 6 losses to form the basis of a claim under Section 7 of the Ontario Act. Section 7 provides for the liability of, among others, every person who signs the disclosure document. However, the clear wording of Section 7 requires as a condition

15. Arthur Wishart Act (Franchise Disclosure), 2000 S.O. 2000, c.3, s. 7(1); Franchises Act, S. P. E. I. 2005, C. 36, s. 7(1); Franchises Act S.N.B. 2007, c. F–23.5, s. 7(1); Franchises Act, C.C.S.M. c. F156, s. 7(1). In Alberta, personal liability is included for misrepresentations in the document, but not for non-compliance. Franchises Act, R.S.A. 2000, c.F–23, s. 9(1).
16. 2005 CanLII 25181 (ON CA).
17. The franchisee has a right of action under § 7 of the Ontario Act against: (a) the franchisor; (b) the franchisor’s agent; (c) the franchisor’s broker, being a person other than the franchisor, franchisor’s associate, franchisor’s agent or franchisee, who grants, markets or otherwise offers to grant a franchise, or who arranges for the grant of a franchise; (d) the franchisor’s associate; and (e) every person who signed the disclosure document or statement of material change.
of this personal liability that the loss be “as a result” of the franchisor’s failure to comply with its disclosure obligations. This provision clearly requires proof that the loss incurred by the franchisee was caused by either the misrepresentation or the failure of the franchisor to comply with its Section 5 obligations. For example, a franchisor’s failure to include financial statements that reveal the poor financial health of the franchisor, which in turn contribute to the franchisor’s inability to properly perform its obligations under the franchise agreement, might qualify as one example creating a causal connection.

Instead, the court in *Dig This* found that the mere failure of the franchisor to pay the Section 6 damages amounted to a Section 7 loss resulting from the initial Section 5 failure to provide a disclosure document. Of course, if the franchisor simply pays the amount claimed by the franchisee, the signatories to the disclosure document won’t have to pay the tab, but this does not detract from what the author believes to be the questionable reasoning that underpins the personal liability in the *Dig This* decision. In the author’s view, the court’s decision is a circularity of reasoning, and a fusion of what is intended to be two separate and distinct types of claims, with distinct and identified responsible parties. The individual signatories to a certificate of disclosure (or, in the case of *Dig This*, non-signatory officers and directors) were not intended, in the author’s view, to be held personally liable for the damages found due under a rescission claim *simpliciter*. The fact that they have been has indelibly modified the franchise landscape in Canada.

B. All Material Facts

Canadian franchise disclosure laws require that two categories of information be disclosed to a franchise prospect. First, franchisors must disclose all specified information prescribed by regulation. This is a “closed” list of facts similar to the twenty-three prescribed Items of disclosure found in the FTC Franchise Rule.

The second category of information that franchisors must disclose is an “open-ended” requirement that the disclosure document contain “all material facts, including material facts as prescribed.” The definition of material fact contained in the Ontario Act reads as follows:

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18. *Dig This*, 2005 CanLII 25181 at ¶ 38 (“... s. 7 clearly provides that if a franchisee suffers a loss as a result of a franchisor’s failure to comply in any way with s. 5, the franchisee has a right of action for damages. Failure to comply in any way with s. 5 includes a failure to provide the disclosure document that the section requires. In circumstances where a franchisor fails to make the payments required of it under s. 6(6), those damages could include such amounts. As well, if a franchisee suffered any other loss as a result of the franchisor’s failure to comply with s. 5, the franchisee may sue for such damages under s. 7.

19. Id. at ¶ 49.

20. The requirement to disclose all material facts was likely an introduced oversight. Alberta’s original franchise legislation, introduced in 1971, was securities-type disclosure requiring a certificate from the filing franchisor stating that the document made “full, plain and true” disclosure. When that Act was completely revised in 1995, the wording of the certificate was modified to require that the disclosure document “contain all material facts including [those]... set out in
material fact includes any information about the business, operations, capital or control of the franchisor or franchisor’s associate or about the franchise system that would reasonably be expected to have a significant effect on the value or price of the franchise to be granted or the decision to acquire the franchise; . . . 21

In light of the breadth of this definition, the list of what might constitute a material fact is limitless. Although the definition requires that the information have “a significant effect on the value or price of the franchise . . . or the decision to acquire the franchise,” 22 there is no requirement that the value be negatively affected. Based on the definition, even a material fact that might have a significant positive effect on the value or price of the franchise must be disclosed.

Franchisees argue that the additional information required by the “all material facts” language is important for them to consider in making the decision to invest in a particular franchise. However, the author believes that when the legislature departed from the certainty of a closed list of disclosure items and required disclosure of information about a franchisor or a franchise system that might have a significant effect on price, or the decision to buy, it created problems of where to draw the line. The following list is a sampling of issues the author has had to consider with clients and decide whether to disclose: (1) information regarding industry trends; (2) information known to the franchisor about competition to the franchise system; (3) information about suppliers (agreements coming up for renewal, disputes, supply to competitors, etc.); (4) future plans for development and expansion (foreign and international); (5) information about products in development; (6) retirement plans of key executives; (7) health issues facing key executive and significant shareholders; (8) financial difficulties of the franchisor; and (9) deteriorating banking relationships and capitalization issues generally. This list is by no means exhaustive. And in the author’s experience, most franchisors will be reluctant to reveal much or any of this information. Conversely, one can only imagine the list of questions asked by counsel for a franchisee on an examination for discovery (in the United States, a deposition) in order to discover facts known to the franchisor that were not disclosed.

C. Site-Specific Disclosure (!)

Yes, you read that correctly. The Court of Appeal of Ontario in 6792341 Canada Inc. v. Dollar It Limited 23 held that a generic form of disclosure document was not adequate to allow a prospect to make an “informed” decision regarding a proposed purchase of a franchise. In particular, the court found

schedule 1.” A strong argument therefore exists that the open-ended “all material facts” disclosure regime started in Alberta and was replicated without serious consideration across the country.

22. Id.
23. 2009 ONCA 385 (CanLII); 95 OR (3d) 291; 310 DLR (4th) 683; 60 BLR (4th) 1; 250 OAC 280.
that the disclosure document lacked information regarding the specific territory to be granted, as well as a copy of the head lease for that particular property. The court made this finding despite the fact that the definition of “material fact” in the Ontario Act, and none of the information that the general regulation requires franchisors to disclose, mentions anything about a specific location. Instead, the author believes the court ignored the first part of the definition:

material fact includes any information about the business, operations, capital or control of the franchisor or franchisor’s associate or about the franchise system \(^{24}\) (which, on its face, makes no mention of location) and focused solely on the second part of the definition:

that would reasonably be expected to have a significant effect on the value or price of the franchise to be granted or the decision to acquire the franchise; . . . \(^{25}\)

in order to conclude that to satisfy the test of compliant disclosure, the prospective franchisee must receive “full and accurate disclosure . . . so the [prospect] can make a properly informed decision about whether or not to invest in a franchise.” \(^{26}\)

The advent of site-specific disclosure obligations has exponentially increased the time and energy expended by franchisors and their counsel to provide compliant disclosure and has resulted in a concomitant increase in the risk of failing to do so. The idea that one can hand out a “one size fits all” disclosure document, and then proceed with the business of finalizing the terms of the franchise agreement and development of the location, must be completely discarded.

In response to the *Dollar It* decision, franchisors developed various “site specific” disclosure strategies. \(^{27}\) One strategy saw the franchisor use a two-stage process of disclosure. At the initial phase, the franchisor would deliver a complete “generic” form of disclosure document and receive a receipt for that disclosure. Once a site was selected and a deal negotiated, the franchisor prepared the final documents for execution, appended them to the generic form of disclosure document together with any other documents relevant to the location (for example, master leases or head leases and supply agreements), and sent all of these documents to the prospect. The franchisor would then provide the franchisee with a second fourteen-day cooling off period. Franchisors then collected monies and signed-around agreements only after the second cooling off period ended. A second strategy shortened this process by including the site-specific materials, information, and agreements into a Statement of Material Change, which may be delivered at any time

\(^{24}\) Arthur Wishart Act (Franchise Disclosure), 2000 S.O. 2000, c.3, subsection 1(1) (emphasis added).

\(^{25}\) Id. (emphasis added).

\(^{26}\) Dollar It, 2009 ONCA 385, at ¶ 16.

\(^{27}\) Which, if the court’s decision in *Raibex*, discussed *infra*, Section I.D., is upheld on appeal, must be closely re-examined.
prior to payment of consideration or execution of documents without re-
starting the fourteen-day cooling off period.

In deciding on any course of action or in advising clients, counsel should
bear in mind that the Ontario Act is being, for the most part, strictly con-
strued against the interests of franchisors, as mandated by this edict of the
Ontario Court of Appeal:

The purpose of the legislation is to protect franchisees and the mechanism for so
doing is the imposition of rigorous disclosure requirements and strict penalties for
non-compliance. The legislation must be considered and interpreted in light of
this purpose.28

Prospective franchisees may believe that strict construction of the Ontario
Act against franchisors is necessary to balance what they see as the unequal
bargaining power of franchisors and prospective franchisees. But the eco-
nomic and administrative burden placed on franchisors to provide generic
disclosure followed by a disclosure document specifically tailored to the
facts and circumstances of each and every location is hard to quantify,
even if the somewhat faster and simpler Statement of Material Change op-
tion is employed. As most U.S. practitioners know, such a practice would
be illegal in any registration state, where franchisors are permitted only to
deliver the form of document on record with the state.29 Aside from the
cost and inconvenience (including a second fourteen-day cooling off period),
the opportunity for administrative error, technical oversight, or substantial
omission multiplies the risk exponentially that the franchisor may be exposed
to a claim for rescission, and its concomitant personal liability, discussed pre-
viously under the heading of “Expansive Personal Liability.”

As a decision of the Ontario Court of Appeal, the impact of the Dollar It
decision will be pervasive and long-lasting. This article provides two appen-
dices to assist practitioners in dealing with the repercussions of the Dollar It
decision, including a questionnaire to help determine whether an entity is an
associate of the franchisor30 and a summary checklist of the missing material
facts that the Court of Appeal found fatal to the disclosure document. As a
further assistance to the practitioner, this article includes suggested wording
for a limitation of an attorney’s retainer relative to any franchise disclosure
work to be undertaken.

29. For example, Section 10 of the Illinois Franchise Disclosure Act provides that: “No fran-
chisor may sell or offer to sell a franchise in this State . . . unless the franchisor has registered
the franchise with the Administrator by filing such form of notification and disclosure statement as
required under Section 16.” 815 ILL. COMP. STAT. 705/10.
30. Whether an entity is an “associate” of the franchisor is critical in all Canadian jurisdic-
tions. Under Dollar It, a failure to correctly identify all associates of the franchisor and to include
the prescribed information (and all other material facts) relative to those associates, may result in
a finding of “no disclosure” being made.
D. Raibex and Premature Disclosure

The issue of site-specific disclosure obligations is particularly problematic in light of the recent decision of the Ontario Superior Court of Justice in Raibex Canada Ltd v ASWR Franchising Corp. Decided in the late fall of 2016, and currently under appeal, Raibex is highly problematic to franchisors who sign franchise agreements with prospects before a site has been selected. In Raibex, the franchisee sought to rescind the franchise agreement on the basis that the disclosure document was deficient in content and that the form of certification attached to the disclosure document was also deficient. Given that the franchisor had delivered a disclosure document and that more than sixty days had elapsed since the date of signing of the franchise agreement, it was necessary for the franchisee to show that the disclosure provided amounted to no disclosure for purposes of the Ontario Act.

In mid-October 2012, the franchisor delivered its disclosure document to the principals of the franchisee prospect. Approximately four weeks later, the franchisor obtained a signed copy of the franchise agreement, and its agent received payment of the franchise fee. However, at the time the parties signed the franchise agreement, they had not yet selected a site or executed a head lease. Accordingly, although the franchisee received the franchisor’s standard form of sublease, it did not receive a copy of the head lease until sometime later during lease negotiations.

After a few months of operating its location, the franchisee brought a claim for rescission and moved for summary judgment. The franchisee based its claim for rescission on a number of alleged deficiencies in the franchisor’s disclosure document, including a failure to include a copy of the head lease; a failure to disclose adequate estimates for the development costs of the franchise; deficiencies in the disclosure certificate, which was signed by the sole officer and director of the franchisor; and a failure to deliver the disclosure document as one document at one time.

The trial judge found that the franchisee was entitled to rescind the franchise agreement both because the disclosure document did not include a copy of the head lease for the location, and because there was insufficient disclosure with respect to the estimated development costs of the restaurant. The trial judge acknowledged that the practice of selecting a location after signing a franchise agreement “may not be unusual,” but nonetheless found that it gave rise to a material deficiency in the disclosure provided.

31. 2016 ONSC 5575.
32. Id. at ¶ 58.
33. Id. at ¶ 55.
34. Id. at ¶ 13.
35. Id. at ¶¶ 23–24.
36. Id. at ¶ 25.
37. Id. at ¶ 28.
38. Id. at ¶ 55.
39. Id. at ¶ 114.
The judge based her finding on what she described as the potential for franchisors to abuse prospective franchisees by disclosing “prematurely” and thus avoid the requirement to disclose material facts that are not yet known.40 The court reached this conclusion despite finding no evidence of any such “abuse” by the franchisor in this case.41 The judge gave little or no weight to the fact that the franchisee was given the option to decline the location in question and receive his deposit back, or continue to look for a different location, and opted to accept the location.42

The judge also found that the development cost estimate provided to the franchisee was materially deficient, and itself formed the basis for a valid rescission claim.43 Although the actual development cost was in line with the pro forma development cost contained in the disclosure document, the development cost in the disclosure document related to construction from a “shell” structure, as opposed to the conversion of an existing location, which this franchisee developed. The judge once again stated that disclosure ought to have followed a determination that the development would be made relative to an existing structure, rather than from a shell.44 The disclosure document in question did contain broad disclaimers concerning cost estimates. The judge, however, stated that disclaimers do not excuse a franchisor from its mandatory disclosure obligations and furthermore may themselves amount to an admission that the franchisor could not meet its statutory disclosure obligations.45

**Raibex**, simply stated and if upheld on appeal, means that a franchisor may not disclose to a prospect until all material facts are known. The practical implication of the case to franchisors is enormous. Many systems will disclose to a prospect and commence training pending a final site selection. Now, franchisors will have to wait to disclose until a site is found and an accurate development cost estimate for the location is determined. This creates a potential risk that franchisors who enter into binding leases may, after disclosing to the prospect, find themselves without a franchisee for the location. It also means that a franchisor cannot train the franchisee or expose it to any of the franchisor’s confidential information prior to finding a location, because the franchisor cannot enforce a confidentiality agreement signed prior to disclosure.

**E. What Constitutes a Loss and Accounting for Profits**

In the **Springdale Pizza** series of cases,46 the franchisor sought to reduce the amount it had to pay to a franchisee for supplies and equipment on a rescission claim under Section 6(6) of the Ontario Act. The franchisor claimed

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40. *Id.* at ¶ 73.
41. *Id.* at ¶ 76.
42. *Id.* at ¶ 27.
43. *Id.* at ¶ 114.
44. *Id.* at ¶ 85.
45. *Id.* at ¶ 83.
46. *Springdale* is a confusing case to track because there are so many decisions and appeals. For a summary of the various decisions, see Mary Paterson, *Springdale Pizza, Eleven Decisions on Disclosure, Rescission and Damages (and Counting)*, Osler Update (May 2014), https://www.
that the equipment was in very poor condition and that the franchisee was therefore “unable” to return the equipment.47 The Master found that the poor condition of the equipment was in part caused by the franchisor’s lengthy opposition to the franchisee’s attempts to rescind the franchise agreement.48 Because the Ontario Act is intended to be remedial, the Master stated that the franchisee had no duty to mitigate, and that the franchisor’s obligation to repurchase the equipment existed regardless of its condition.49 Presumably the rescinding franchisee must still be in possession of the equipment for which he or she seeks reimbursement, i.e., it would not be enough to claim reimbursement for equipment that the former franchisee no longer possessed.

In Springdale Pizza, the rescinding franchisee had earned a small net profit during the period of operation prior to rescission.50 The issue was not whether a profitable franchisee had the same right to rescind as a franchisee that had incurred losses; rather, the court was asked to determine whether the net profits of the franchisee should be set off against the losses for which the franchisee was to be compensated pursuant to Sections 6(6)(a)–(c) of the Ontario Act, or whether the franchisee was simply entitled to no compensation pursuant to Section 6(6)(d) of the Ontario Act. The court concluded that the Ontario Act does not provide for a franchisor to set off any revenue against other amounts awarded. The court stated: “if it were otherwise, sections (a) to (c) of the Act would not be necessary. A single section providing compensation for losses would suffice if the intention of the Act was simply to put a franchisee back into its former position.”51

And so, at least in Ontario, a rescinding franchisee may end up better off than he would otherwise have been had he never purchased the franchise.

F. Failure of the Franchisor to Provide Support

In Allied Domecq Retailing International Canada Ltd. v. Bertico Inc., after a trial on the merits, twenty-one Québec-based Dunkin’ Donuts franchisees received a damages award exceeding $16 million for lost profits for the repeated and continuous failure of the franchisor to fulfill its obligation to protect and enhance the Dunkin’ Donuts brand in response to competition in Québec from the Tim Horton’s brand.52 The franchisees also succeeded in their claim that the franchisor failed to enforce brand standards and tolerated under-performing franchisees that caused damage to the brand.53
On appeal, Dunkin’ Donuts argued that the trial division decision was “unprecedented in the annals of franchise law, not only in Québec and Canada but also in the United States” and that the court mistakenly imposed on it “a new unintended obligation to protect and enhance the brand, outperform the competition and maintain indefinitely market share.” The Court of Appeal upheld the trial decision, but reduced the damages to around $10 million. In upholding the decision, the Court of Appeal found that the duty of good faith, well-established in the province, imposed an obligation on the franchisor to provide a certain level of support. In reliance on this principle, the Court of Appeal endorsed the trial judge’s finding that the franchisor had breached a number of “explicit obligations as well as obligations that may be inferred from their nature.” The court stated:

Applying the law to the facts, the judge decided that the most important explicit obligation agreed to by the Franchisor was its promise ‘to protect and enhance both its reputation and the ‘demand for the products of the Dunkin’ Donuts System;’ in sum, the brand.

In the trial court’s view, the franchisor had done neither. The trial court ascribed “a host of other explicit and implicit failings” to the franchisor during the period from 1995 to 2005: (1) failure to consult, support, and assist the franchisees; (2) absence of a corporate store to train new staff and test new products; (3) inordinately high turnover of its executives; (4) too few consultants for the network of franchisees; (5) failure to remove under-performing franchisees from the network; and (6) implementation and subsequent withdrawal of frozen products. The trial court concluded that these faults had “for the most part been substantiated convincingly from the evidence adduced by the Franchisees and from the acknowledgments and admissions flowing from several of Defendant’s witnesses and exhibits.”

In the ordinary course, the author would say that a decision of a Québec court is not of significant precedential value, given its typical reliance on provisions of the Civil Code (i.e., decisions of Québec courts are not considered to have precedential value in the common law courts of the other provinces). In this case, however, the decision included an interpretation of

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54. Id.
57. Id. ¶ 32.
58. Id.
59. Id.
60. Although cited in several subsequent decisions of Québec courts, the Dunkin’ Donuts decision has not been cited by a common law court of any province. Furthermore, certain commentators have suggested that the case is constrained in its application as a result of the court’s reliance on a specific provision of the Code Civil; namely article 1434, which provides that “a contract validly formed binds the parties who have entered into it not only as to what they have expressed in it but also as to what is incident to it according to its nature and in conformity with usage, equity or law.” See Jennifer Dolman & Alexandre Fallon, Dunkin Donuts Decision has
the plain meaning of contractual provisions and consideration of the business judgement rule, legal concepts well known in the common law. The Court of Appeal dismissed the franchisor’s reliance on the business judgment rule stating that:

The Franchisor proposes to apply the business judgment rule without regard to its proper meaning in order to avoid ordinary liability for breach of contract to the Franchisees as independent businesses under the franchise agreements. The parameters of the business judgment rule, described notably by the Supreme Court in *Peoples' Department Store*, especially paras. 64 to 66, are both well-known and limited in scope in matters of civil liability. The rule is usually applied in matters relating principally to the personal responsibility of directors and officers to shareholders and not as a means of exculpating a corporate contracting party from liability for fault under a contract with third parties. As legal scholars have explained, the rule is designed to allow for directors to take appropriate risks without undue fear of personal liability, *but not as a shield against civil liability of their corporations*.

The case is also notable because although it was appealed to the Supreme Court of Canada, the court refused to hear the appeal, thereby effectively affiriming the decision.

G. Disclosure Relative to “Franchisor’s Associates”

Among other things, the court in *Dollar It* found that the disclosure document was non-compliant because it did not contain information about a “franchisor’s associate” that was sufficiently adequate to permit the prospect to make an informed decision to purchase the franchise. This niggling detail might easily escape the notice of a practitioner.

Who is a franchisor’s associate? The definition from the Ontario Act reads as follows:

“franchisor’s associate” means a person, (a) who, directly or indirectly, (i) controls or is controlled by the franchisor, or (ii) is controlled by another person who also controls, directly or indirectly, the franchisor, and (b) who (i) is directly involved in the grant of the franchise, (A) by being involved in reviewing or approving the grant of the franchise, or (B) by making representations to the prospective franchisee on behalf of the franchisor for the purpose of granting the franchise, marketing the franchise or otherwise offering to grant the franchise, or (ii) exercises significant operational control over the franchisee and to whom the franchisee has a continuing financial obligation in respect of the franchise.

The definition requires that two criteria be met. First, by part (a), the persons have to be under common control. That frequently happens when a group of corporations exists within a franchise system, each fulfilling a dif-

64. *Arthur Wishart Act (Franchise Disclosure)*, 2000 S.O. 2000, c.3, s. 1(1)
ferent function. Second, by part (b), the associate has to be directly involved in the grant of the franchise, or exercise significant operational control over a franchisee which has a continuing obligation under the franchise agreement that is owed to the associate.

Determining who is a “franchisor’s associate” is important not only for the purposes of making accurate and complete disclosure. Section 7 of the Ontario Act also includes a franchisor’s associate in its list of those who may be personally liable for damages under that section (which, may include damages for rescission under Section 6).65

The *Dig This* decision was the first decision of the Court of Appeal to consider the definition of franchisor’s associate. In that case, two individuals who each owned fifty percent of the shares were found to be associates of the franchisor on the basis of their control66 and on the basis that both were directly involved in granting the franchise to the respondents by making representations to the respondents on behalf of the franchisor.67 Accordingly, the court in *Dollar It* determined that the corporate sub-landlord of the franchisee was an associate of the franchisor.68 The two corporations (the sub-landlord and the franchisor) shared common ownership, but is it fair to say that a sub-landlord exercises significant operational control over a franchisee? Certainly any lease has many, many operational provisions, but are they relevant to the franchise relationship? And likewise, just because the franchisee is paying rent, is that payment relevant to the franchise relationship? Equally strange, a different panel on a cross-appeal of *Dollar It* found the individual in question to be a franchisor’s associate based solely upon an analysis of the first branch of the test (control), without considering the second branch of the test, namely involvement in the grant of the franchise or operational control.69

Although potentially a subject of debate, until legislative change or a new line of cases emerges, the conclusion is that any entity:

- under common control;
- exercising any operational control (which will most likely be found to be present in the form of a contract such as a lease or supply agreement); and
- to whom the franchisee makes payments

should be considered a “franchisor’s associate,” and the relevant disclosure made.

65. See discussion, *supra* Section I.A.
66. Oddly, the court did not reference the definition of “deemed control” under § 1(3) that requires that voting securities carrying *more than* fifty percent of the votes for the election of directors be held for a finding of deemed control.
67. 1490664 Ontario Ltd. v. *Dig this Garden Retailers Ltd.*, 2005 CanLII 25181 (ON CA) at ¶ 43.
68. 6792341 Can. Inc. v. *Dollar It Ltd.*, 2009 ONCA 385 (CanLII) at ¶ 42.
69. *Id.* at ¶ 5 (“In our view, it is clear that the finding that Merali controls the franchisor renders him a franchisor’s associate for the purpose of the Act . . .”).
H. What Needs To Be Disclosed About “Franchisor’s Associates”

1. Material Facts

As mentioned above, all Canadian jurisdictions require disclosure of all “material facts.” The definition of material fact includes “...any information about the business, operations, capital or control of the... franchisor’s associate.”

What then, is material? It is frankly impossible to say that any particular fact might not be of interest to a prospective franchisee. For example, the fact that the president’s mother has voting control of the franchisor corporation is of interest. How old is she? Where does she live? Is she in good health? Does she exercise good business judgement? Has she ever been bankrupt (if she is not an officer or director, and is not involved in the grant of franchises, this will not be mandated disclosure)? Is she of sound mind? What happens to voting control on her death? One can say that any one of these facts and a hundred more would be of interest to a prospective franchisee.

The author believes that sound business and legal arguments can be made to the effect that the list of prescribed facts set out in Canadian franchising regulations (collectively, the Regulation) should be considered full and complete disclosure, subject to the usual proviso found in the United States that any claim that contradicts the information found in the disclosure document will constitute an unfair and deceptive trade practice, or the failure to state a fact required to be included so that the information is not otherwise misleading.

The judge in Dollar It said “by having no information about [the sub-landlord], the franchisee cannot make an informed decision in relation to the franchise. It knows nothing about the party with which it is expected to sign a sublease.” This begs the question “how much does a prospect need to know in order to make an informed decision?” It also ignores the reality that this kind of information is not generally available in non-franchise situations. Why then, are franchises treated differently? And even in franchise situations, the franchisee won’t be entitled to disclosure about an arm’s-length landlord.

70. Arthur Wishart Act (Franchise Disclosure), 2000 S.O. 2000, c.3, s. 1(1); Franchises Act, S. P. E. I. 2005, C. 36, s. 1(1); Franchises Act S.N.B. 2007, c. F–23.5, s. 1(1); Franchises Act, C.C.S.M. c. F156, s. 1(1); Franchises Act, R.S.A. 2000, c.F–23, s. 1(1); Franchises Act, SBC 2015, c 35, s. 1(1).


73. Dollar It, 2009 ONCA 383, at ¶ 44.
The Regulation requires the following disclosure to be made about a franchisor’s associate:

2.3. A statement, including a description of details, indicating whether, during the ten years immediately preceding the date of the disclosure document, the franchisor’s associate has been convicted of fraud, unfair or deceptive business practices, or a violation of a law that regulates franchises or business or if there is a charge pending against the person involving such a matter;

2.4 A statement, including a description of details, indicating whether the franchisor’s associate has been subject to an administrative order or penalty imposed under a law of any jurisdiction regulating franchises or business or is the subject of any pending administrative actions to be heard under such a law;

2.5. A statement, including a description of details, indicating whether the franchisor’s associate has been found liable in a civil action of misrepresentation, unfair or deceptive business practices or violating a law that regulates franchises or businesses, including a failure to provide proper disclosure to a franchisee, or if a civil action involving such allegations is pending against the franchisor’s associate;

2.6. Details of any bankruptcy or insolvency proceedings, voluntary or otherwise, any part of which took place during the six years immediately preceding the date of the disclosure document, against the franchisor’s associate;

6.4. The terms and conditions of the financing arrangements that the franchisor’s associate offers directly or indirectly to franchisees;

6.5. A description of any training or other assistance offered to franchisees by the franchisor’s associate, including whether the training is mandatory or optional, and if the training is mandatory, a statement specifying who bears the costs of the training;

6.6. If the franchisee, as a condition of the franchise agreement, is required to contribute to an advertising fund, a statement describing the percentage of the fund, other than the percentage described in sub-subparagraph A, that has been retained by the franchisor’s associate in the two fiscal years immediately preceding the date of the disclosure document;

6.6 Another statement describing, a projection of the percentage of the fund to be retained by the franchisor’s associate in the current fiscal year;

6.7. A description of any restrictions or requirements imposed by the franchise agreement with respect to obligations to purchase or lease from the franchisor’s associate or suppliers approved by the franchisor’s associate;

6.8. A description of whether the franchisor’s associate receives a rebate, commission, payment or other benefit as a result of purchases of goods and services by a franchisee and, if so, whether rebates, commissions, payments or other benefits are shared with franchisees, either directly or indirectly;

6.9. A description of the rights the franchisor’s associate has to the trade-mark, service mark, trade name, logo or advertising or other commercial symbol associated with the franchise; and

6.16. For each closure of a franchise of the type being offered within the three fiscal years immediately preceding the date of the disclosure document, the reasons for the closure, including whether the franchisor’s associate terminated or cancelled the
Accordingly, the preparation of a compliant disclosure document requires adequate care and attention be directed to this aspect of disclosure. This is especially true for foreign systems entering the Canadian market, since the concept of “franchisor’s associate” is not in use outside Canada. To assist with this analysis, this article includes a questionnaire at Appendix A to help identify entities that may qualify as “franchisor’s associates” under Canadian law.

2. Material Changes

A material change is defined as follows:

[A] change in the business, operations, capital or control of the franchisor or franchisor’s associate, or a change in the franchise system, or a prescribed change, that would reasonably be expected to have a significant adverse effect on the value or price of the franchise to be granted or the decision to acquire the franchise and includes a decision to implement such a change made by the board of directors of the franchisor or franchisor’s associate or by senior management of the franchisor or franchisor’s associate who believe that confirmation of the decision by the board of directors is probable.

Material changes in the business, operations, capital, or control of the franchisor and of the franchisor’s associate(s) need to be disclosed. The period during which material changes need to be disclosed starts on the date that disclosure is made and ends (subject to the proviso that the initial disclosure was not premature, as per Raibex) on the date an agreement relating to the franchise is signed, or a payment is made.

As with the definition of “material fact” discussed previously, the author believes the definition of material change was clearly never intended to apply to a particular location, because it references only the franchisor, the franchisor’s associate, and the franchise system—with no mention of the proposed location or business under negotiation. However, the author has little confidence in a post-\textit{Dollar It} court to make this distinction, and accordingly the same site-specific disclosure strategy is recommended when a material change occurs to information that has previously been disclosed to a prospect.

\textit{Franchise agreement}, or the franchisor’s associate refused to renew the franchise agreement.\footnote{General Regulation 581/00, made under the \textit{Arthur Wishart Act (Franchise Disclosure)}, 2000 S.O. 2000, c.3, Part II, s. 6.16 (emphasis added).}

\footnote{Arthur Wishart Act (Franchise Disclosure), 2000 S.O. 2000, c.3, s. 1(1); Franchises Act, S. P. E. I. 2005, C. 36, s. 1(1); Franchises Act S.N.B. 2007, c. F–23.5, s. 1(1); Franchises Act, C.C.S.M. c. F156, s. 1(1); Franchises Act, R.S.A. 2000, c.F–23, s. 1(1); Franchises Act, SBC 2015, c 35, s. 1(1).}

\footnote{Arthur Wishart Act (Franchise Disclosure), 2000 S.O. 2000, c.3, s. 5(5); Franchises Act, S. P. E. I. 2005, C. 36, s. 5(5); Franchises Act S.N.B. 2007, c. F–23.5, s. 5(6); Franchises Act, C.C.S.M. c. F156, s. 5(7); Franchises Act, R.S.A. 2000, c.F–23, ss. 4(4),(5); Franchises Act, SBC 2015, c 35, s. 5(6).}
I. Form over Substance

The author believes that the notion of “no harm, no foul” has found no traction in the judicial interpretation of the disclosure requirements under the Canadian Acts. On the contrary, the author posits that a rigorous technical approach has been the order of the day. Perhaps no better example of this can be found than in the willingness of the courts to dispense with an entirely compliant franchise disclosure document because the certificate of disclosure is unsigned. In reality, of course, whether a disclosure document is signed or not adds nothing to the quality or quantity of the information disclosed. The author sees a certain irony in that the court in Dig This justified its edict that disclosure with an unsigned certificate amounted to no disclosure because the required signatures of officers and directors on the document provided the statutory basis for personal liability, while simultaneously imposing personal liability on the officers and directors of the franchisor whose signatures were absent from the certificate! Clearly, the courts’ conclusion that signatures are necessary to form the basis for a claim against those individuals is difficult to understand. All the court need do, as it did in Dig This, is to find those same individuals to be “franchisor’s associates,” and the personal liability then flows as a result of the conflation of Sections 6(6) and 7.

Springle Pizza, a decision of the Ontario Court of Appeal, is in the author’s opinion another victory of form over substance. First, the court noted that the financial statements were Notice to Reader statements. The franchisor argued that, effectively, this did not alter the quality, accuracy, or sufficiency of the information provided to the prospect. The Court of Appeal stated that inclusion of review engagement statements was mandatory and that anything less was materially deficient. Second, the Court of Appeal also upheld the motion judge’s finding that the certificate of disclosure was deficient because it contained only one signature of an officer or director, instead of the required two signatures. Although the franchisor tendered evidence that a second certificate signed by another officer had been provided on the same day, the Court of Appeal rejected this as a violation of the requirement that the certificate must be a solitary document, not two.

On the latter point, it is true that the majority of Canadian jurisdictions require that the disclosure document be delivered “as one document, at one time.” Alberta does not require delivery of the disclosure document as a single document at one time. This, along with a “substantial compli-

77. See Dollar It, 2009 ONCA 385.
79. Dig This, 2005 CanLII 25181.
80. See discussion, supra Section I.A.
82. Arthur Wishart Act (Franchise Disclosure), 2000 S.O. 2000, c.3, s. 5(3); Franchises Act, S. P. E. I. 2005, C. 36, s. 5(3); Franchises Act S.N.B. 2007, c. F–23.5, s. 5(3).
ance” provision in the Alberta Act\(^{83}\) has, on occasion, permitted a more flexible review by the courts on the adequacy of disclosure, rather than an “all or nothing” approach.\(^{84}\) However, the substantial compliance provision found in the Alberta regulation, which states that “a disclosure document is properly given . . . if the document is substantially complete” did not save the disclosure document in the Hi Hotel\(^{85}\) decision, where the absence of a signed certificate of disclosure was held to be a fatal flaw. Manitoba appears to have attempted to avoid an overly technical approach to the interpretation of its Act by stating that “substantial compliance” will satisfy the requirements of the Manitoba Act, “even if the disclosure document contains a technical irregularity or mistake not affecting the substance of the document.”\(^{86}\) British Columbia’s Act, the newest on the Canadian legislative stage, appears to go even further, allowing “a defect in form, a technical irregularity or an error . . .”\(^{87}\) Time will tell whether courts will give effect to these legislative directives for a purposive approach to statutory interpretation.

The Court of Appeal for Ontario, in a decision just released, further entrenched what the author sees as a formalistic approach to interpretation of the Ontario Act. In \textit{Mendoza v. Active Tire & Auto Centre Inc.},\(^{88}\) the franchisee brought a motion for summary judgment, seeking rescission. The motions judge reviewed the franchisee’s prior business experience and found it significant that the franchisee had employed a franchise broker, an accounting firm, and a boutique financial and legal firm as part of his investigation of the franchise. The franchisee was provided with a 175-page disclosure document and a number of other documents over approximately three months, after which he signed the franchise agreement and paid a franchise fee.

The franchisee based his claim for rescission on five defects in the disclosure document. First, the disclosure document was signed by the franchise development manager, and not by two officers or directors of the franchisor. Second, only a portion of the franchisor’s financial statements was included in the disclosure document. Third, the materials provided to the franchisee were not delivered at one time as part of a single document. Fourth, the letter of credit provided by the franchisee was markedly different than the one described in the disclosure document. Fifth, there were no assumptions and information included as part of the financial projections forming part of the disclosure document. The motions judge held that the franchisee had clearly made an “informed decision.” He received “extensive material.” The judge was also clearly vexed by the franchisee’s refusal to answer questions about any “misleading or deficient portions” of the disclosure document. Interest-

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83. General Regulation 240/95, s. 2(4).
86. \textit{Franchises Act}, C.C.S.M. c. F156, s. 5(10) (emphasis added).
87. \textit{Franchises Act}, SBC 2015, c 35, s. 9.
88. 2016 ONSC 3009.
ingly, the judge used the Court of Appeal’s decision in Dollar It to underpin his decision. He noted that in that case, the court conducted an analysis of what documents were provided to the prospect which led the court to conclude that “the stark and material deficiencies in the disclosure document in this case did not meet the requirements of the Act.”\textsuperscript{89} These deficiencies led the prospect in Dollar It to make an uninformed decision to enter into the franchise agreement.

In addition, the motions judge stated that “for me, an analysis of the nature and extent of the deficiencies is required as part of reaching a conclusion as to whether the disclosure document exists.”\textsuperscript{90} He concluded that the franchisor did provide sufficient documentation to the prospect to allow him to make an informed decision, even though the disclosure document was not in full compliance with the Act. The deficiencies were not significant or misleading.\textsuperscript{91}

The Court of Appeal disagreed and permitted the franchisee to rescind.\textsuperscript{92} The franchisor’s failure to have the disclosure document signed by two officers or directors was a material deficiency. According to the court, this provision of the Ontario Act and Regulation gives the franchisee substantive rights against the signatories to the document and impresses upon those who sign the document the importance of ensuring that the document is complete and accurate.\textsuperscript{93} The court also found that the franchisor’s failure to produce current financial statements\textsuperscript{94} amounted to no disclosure.\textsuperscript{95} The court concluded by noting that: “If the franchisor cannot [provide the required information to prospective franchisees within the prescribed time] it cannot comply with the Act . . . [and] it cannot proceed to engage with prospective franchisee’s or operate a franchise system as defined in the Act.”\textsuperscript{96} And so, at least for the time being, franchisors and their counsel cannot rely on a document that substantially complies: strict technical compliance is the applicable Canadian standard.

\section*{II. A Review of Norms of Judicial Construction}

It has been interesting for the author to watch courts justify some interpretations of the Ontario Act. Many of the surprising judicial decisions have been justified by a “purposive” approach to the legislation. The purpose of franchise

\textsuperscript{89} Id. at ¶ 22.
\textsuperscript{90} Id. at ¶ 23.
\textsuperscript{91} Id. at ¶ 24.
\textsuperscript{92} 2017 ONCA 471.
\textsuperscript{93} Id. at ¶ 24.
\textsuperscript{94} The franchisor delivered financial statements twenty-eight weeks after the end of the franchisor’s fiscal year end. The financial statements should have been delivered no later than twenty-six weeks after the franchisor’s fiscal year end. Id. at ¶ 32.
\textsuperscript{95} Id. at ¶ 33 (“Financial statements are clearly an extremely significant component of the information a prospective franchisee requires in order to the viability of the franchisor’s franchise operations and the safety and security of becoming a franchisee in that franchisor’s system.”).
\textsuperscript{96} Id. at ¶ 34.
disclosure laws, according to these judges, is to protect franchisees. The author believes this approach has only a marginal basis in fact. Nonetheless, it has been animated and re-animated by the Ontario Court of Appeal, where it was expanded from decisions dealing with the duty of fair dealing—where the author believes it might have had some justification—and applied broad-brush to the disclosure provisions of the Ontario Act, where in the author’s opinion it does not properly belong. The purposive approach was first enunciated by the court in *Personal Services Coffee Corp. v. Beer*:

> It is clear, therefore, that the focus of the Act is on protecting the interests of franchisees. The mechanism for doing so is the imposition of rigorous disclosure requirements and strict penalties for non-compliance. For that reason, any suggestion that these disclosure requirements or the penalties imposed for non-disclosure should be narrowly construed, must be met with skepticism.

Similarly, in *MDG Kingston Inc. v. MDG Computers Canada Inc.*, another justice of the Court of Appeal noted:

> Having specifically recognized that franchise agreements may contain arbitration agreements for dispute resolution, the Arthur Wishart Act does not address whether rescission of a franchise agreement for inadequate disclosure will also rescind either a disclosed or an undisclosed arbitration clause. As the purpose of the Arthur Wishart Act is to protect franchisees, one would have expected that had the legislature believed that rescission of the arbitration clause was necessary for that protection, it would have provided that consequence specifically in s. 6, in addition to the reference to penalties and obligations.

The Court of Appeal has repeated this on several occasions, first in the *Dollar It* decision, a case dealing only with disclosure issues, and again in the subsequent *405341 Ontario Ltd. v. Midas Canada Inc.* case, dealing with the franchisor’s duty of good faith and fair dealing:

> The purpose of the Act is to protect franchisees. The provisions of the Act are to be interpreted in that light. Requiring franchisees to give up any claims they might have against a franchisor for purported breaches of the Act in order to renew their franchise agreement, unequivocally runs afoul of the Act.

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97. In addition to the cases cited later in this article, the purposive approach was most recently repeated by the Ontario Court of Appeal in two cases. 2130489 Ontario Inc. v. Philthy McNasty’s (Enters.) Inc., 2012 ONCA 381; Addison Chevrolet Buick GMC Ltd. v. Gen. Motors of Canada Ltd., 2016 ONCA 324.

98. A relatively recent decision rendered by the court sounds to the author like a voice from the wilderness, given that it has been overshadowed by at least two more recent Court of Appeal decisions. In *4287975 Canada Inc. v. Invescor Rests. Inc.*, 2009 ONCA 308, at ¶ 40, LaForme J.A. held that: “[a] fair interpretation of the Act is one that balances the rights of both franchisees and franchisors.” Both the subsequent decisions of the *Dollar It* litigation (see infra note 101) and the *Midas* litigation (see infra note 102) have ignored the “balancing of rights” approach suggested by the court in the *Invescor Restaurants Decision*.


100. 2008 ONCA 656 (emphasis added).


102. 2010 ONCA 478 (CanLII) (emphasis added).
The ambit of the purposive approach was widened by the Court of Appeal in the case of *Salah v. Timothy’s Coffees of the World, Inc.*, when the court stated:

> The Wishart Act is sui generis remedial legislation. *It deserves a broad and generous interpretation.* The purpose of the statute is clear: *it is intended to redress the imbalance of power as between franchisor and franchisee; it is also intended to provide a remedy for abuses stemming from this imbalance.*

Franchisees and their counsel contend that such a “broad and generous interpretation” is the most effective way to address their belief that the franchisor has significantly greater bargaining power. But the author has not been able to find any basis for these judicial pronouncements of the purpose of the legislation. The only support for the interpretation first given life by the court in *Beer*, and consistently re-animated by a subsequent line of decisions, is the report of the Committee members who studied Bill 33 (the predecessor of the Ontario Act) at the committee stage. The author believes the *stated* purpose of the Ontario Act has always been somewhat more prosaic. Consider the statement of the Minister of Consumer Relations upon introduction of Bill 33 to the House:

> Franchising is important to the men and women who see a franchise as a way to achieve their dreams of a better tomorrow. This legislation is a result of extensive consultation and will at the end of the day help small business investors *make more informed decisions and encourage marketplace fairness.*

Nowhere in the Explanatory Note to the Ontario Act does any such protective approach find expression.

At best, the right of association found in Section 4 of the Ontario Act (and in all other provincial legislation except Alberta’s) has the purpose of protecting franchisees. That section expressly grants a right of association and then goes on to prohibit franchisors from interfering with, prohibiting, or restricting the right of association. However, interference with the right of association is rarely pleaded in franchise cases.

Although some may argue that the obligation of fair dealing contained in the Canadian Acts has the purpose of protecting franchisees, the author disagrees because the duty of fair dealing is also owed by franchisees to franchisors. The purpose of the fair dealing provision is therefore intended to protect *both* parties to the franchise agreement. In fact, in reviewing the reported cases, it appears that fair dealing is pleaded just as frequently by franchisors

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105. The name of the Bill was itself somewhat instructive of its purpose: “Bill 33, An Act to require fair dealing between parties to franchise agreements, to ensure that franchisees have the right to associate and to impose disclosure obligations on franchisors.”
as it is by franchisees. For example, some franchisees “free ride” on the franchisor’s brand and trademark while providing below standard quality products or services.  

In a previous Journal article, Bill Killion commented on the inappropriateness of the canon of liberal interpretation by the U.S. judiciary. In his article, he quotes the dissenting opinion in the Nagrampa v. Mailcoup, Inc. as follows:

. . . as with most paternalistic endeavors, the majority’s opinion carries the seeds of great irony. By invoking the unconscionability doctrine to protect the “little guy” in this case [from an agreement to arbitrate] the majority has construed California franchise law in a way that will result in fewer opportunities for the “little guys” in the future because “the ever-growing cost of litigation is one of the most serious and uncontrollable risks faced by modern businesses.

After summarizing the somewhat long and arduous history of the development of franchising and franchise legislation in the United States, Killion adroitly concludes that the resultant laws were the product of a careful balancing of all franchise stakeholders; namely, franchisors, franchisees, consumers, and others (including suppliers in the franchise goods and services chain). In the face of such legislative balancing of interests, the author believes it is not proper for the courts to overlay any canon of interpretation that has the effect of favoring one side of the franchise relationship over the other. The author suggests that the same balancing of interests pertains to the Canadian situation, and that the interpretation of the Acts—especially in the context of defining the disclosure obligations of franchisors—that appear to have the sole objective to protect franchisees, are contrary to the purpose and intent of presale disclosure legislation.

This same kind of judicial activism is apparent in the trend by various courts to impose a duty of utmost good faith (i.e., a fiduciary standard) on franchisors. That trend has now been mostly laid to rest. In the author’s opinion, it is now time to end what appear to the author to be the protectionist proclivities of the Ontario Court of Appeal and approach the Acts in the balanced manner expressed by their clear wording—an approach that is necessary to ensure that the legitimate interests of all franchise stakeholders are protected.

110. 469 F.3d 1257 (9th Cir. 2006).
111. Killion, supra note 109, at 24.
112. Dillon, supra note 3, at 32.
III. Some Promising Judicial Trends

As disappointing as some of the decisions discussed previously may be to the author, there are recent judicial decisions that suggest that some judges subscribe to a more balanced approach in interpreting these statutes. For example, in *Spina v. Shoppers Drug Mart, Inc.*, 113 which was a class proceeding seeking up to $1 billion in compensatory damages, the judge took a very practical and contractually based approach to the various claims put forth by the representative plaintiff. In several instances, the judge unhesitatingly struck the plaintiff’s claims when the contract in question clearly substantiated the franchisor’s conduct. 114 This included the franchisor’s contractual right to receive rebates. Similarly, the court struck the franchisees’ claim for an alleged breach of fiduciary duty, on the basis that the contract made clear that no such duty existed. 115 The case makes clear that a clearly worded contract is essential to limiting the scope of judicial review to the four corners of the agreement.

In the much-anticipated “Tim Horton’s” case, 116 the court dismissed the representative plaintiff’s motion for class certification. The plaintiff alleged a variety of breaches of contract, breach of the duty of good faith and fair dealing, and unjust enrichment against the franchisor of the doughnut store giant. The court took a close look at the actual wording of the franchise agreement and concluded that the franchisor had acted appropriately. According to the contract, the franchisor had the right to receive rebates and to require that all franchisees sell specified items (and conversely that franchisees were not entitled to pick and choose among menu offerings and sell only the most profitable ones). 117 The case stands largely for the proposition that a franchisor has the overall responsibility to determine the design and content of the franchise system and concept and that franchisees must conform to those determinations. Like the *Spina* decision discussed previously, this case highlights the importance of a properly worded franchise agreement. 118

Next, in *Caffè Demetre Franchising Corp. v. 2249027 Ontario Inc.*, 119 the court established some very helpful parameters for the interpretation of the definition of “material fact” under the Act. 120 In *Caffè Demetre*, the fran-
chisor commenced litigation against one of its former franchisees who had started a competing business under a different name about five miles away from a rescinding franchisee. The rescinding franchisee claimed that the franchisor failed to disclose that it was involved in litigation with the former franchisee and certain other alleged material facts, including a new “tipping out” policy that prevented franchisees from taking a portion of employees’ tips, a new policy requiring principals of each franchise location to assume responsibility for making ice cream onsite, and certain remodeling and renovation obligations.121 The court stated that the decision of the Superior Court in Springdale Pizza122 does not stand for the proposition identified by the motions judge, i.e., that any litigation involving a franchisor amounts to material fact—no matter what the nature and circumstances of the litigation.123 Rather, the court stated that “ongoing or prospective litigation involving the franchisor is not, by definition, a material fact. . . . If the litigation in issue does not fall within [subsection 2(5) of the Regulation]124 then whether it is a material fact, as contemplated by the Act, will be a question of fact determined on a case-by-case basis.”125 The court went on to state that given the protective nature of the litigation in question, i.e., that the franchisor was suing a former franchisee to enforce a non-compete covenant generally for the benefit of the remaining franchisees of the Caffè Demetre system, the case did not constitute a potential liability that might attach to the franchise system and would not financially impact the rescinding franchisee’s location; therefore, the lawsuit did not constitute a material fact and hence its disclosure was not required. Moreover, the failure to disclose the litigation against the former franchisee did not effectively deprive the rescinding franchisee of the opportunity to make a properly informed decision to invest in the Caffè Demetre franchise system.

Finally, the decision of Healy v. Canadian Tire Corp.126 is an appeal from a decision of an arbitrator dismissing a claim for damages for negligent misrepresentation while allowing a much diminished claim for damages for breach of the duty of fair dealing. This is one of the few decisions requiring a franchisee to undertake his or her own due diligence. The franchisee argued that he relied on projections given to him by the franchisor, which were inaccurate.127 The projections showed declining sales, yet the evidence showed that the franchisee never made inquiries of the former owner as to

121. Id. at ¶ 20.
122. 2013 ONSC 7288.
124. This section of the regulation requires inclusion of “[a] statement, including a description of details, including whether the franchisor, the franchisor’s associate or a director, general partner or officer of the franchisor has been found liable in a civil action of misrepresentation, unfair or deceptive business practices or violating a law that regulates franchises or businesses, including a failure to provide proper disclosure to a franchisee, or civil action involving such allegations is pending against the person.” General Regulation 581/00, made under the Arthur Wishart Act, 2000 S.O. 2000, c.3, Pt. III, s. 2.5.
126. 2012 ONSC 77.
127. Id. at ¶ 6.
why sales were declining.128 The arbitrator found that if the franchisee had wanted more information he could have asked for it, but did not.129 The franchisee did not inquire into the basis for the franchisor’s projections nor did he question any of the apparent discrepancies between the various reports provided to him.130 The arbitrator found that it was not reasonable for the franchisee to rely upon the franchisor’s projections where he was aware of declining sales at the store prior to deciding to taking it over.131 As for the franchisee’s allegations that the franchisor breached its duty of fair dealing, the arbitrator considered the franchisee’s own breaches, stated that “fair dealing is a two-way street,” and held that the franchisee’s breaches had the effect of significantly reducing any remedy that might otherwise be granted as result of the franchisor’s breaches.132

IV. Legislative Updating Required

The author suggests that the time is at hand for some statutory or regulatory updating of the various Acts and, in particular, the Ontario Act. Ideally from the author’s viewpoint, such reform would occur on a cooperative basis, with all six regulating jurisdictions amending their acts together for consistency. Recently, the Ontario Business Law Advisory Council133 and the Franchise Law Section of the Ontario Bar Association134 recommended revisions and updates to the Ontario Act and Regulation that would address some of the current issues in the legislation highlighted in this article. However, it appears that the government of the day in Ontario is prepared only to make what amount, in the author’s viewpoint, to cosmetic changes to the Ontario Act. The changes in Bill 154,135 introduced on September 14, 2017, include: eliminating references to “service marks,” which have no application to Canadian trademark law and were erroneously imported into the Act at its inception; clarifying in the definition of “franchise” that association with a trademark licensed to the franchisor will satisfy the trademark requirement; and clarifying that under the fractional franchise exemption, the period of time to be used in assessing anticipated sales is one year. The Bill, if implemented, would introduce some helpful changes, including: the ability of a

128. Id. at ¶44.
129. Id. at ¶28.
130. Id.
131. Id.
132. Id. at ¶63.
franchisor to enter into a confidentiality agreement or site selection agreement with a prospect without the need to provide disclosure beforehand, and the ability to require payment of a fully refundable deposit prior to disclosure. In the author’s view, Ontario’s proposed changes fall far short of beginning the process of swinging the pendulum toward what the author believes to be a more fair and balanced interpretation that considers the legitimate views and interests of all stakeholders: franchisees, franchisors, and consumers of the goods and services delivered via the franchise model.

V. Conclusion

The author suggests that Canadian franchise legislation and its judicial interpretation has led to a substantial increase in compliance costs to franchisors and a substantial risk of devastating damage awards, including personal liability to the principals of franchisors. These risks are often based on minor or technical failures in the franchisor’s disclosure document or disclosure processes. In the author’s experience, this has caused offshore systems to reconsider expansion into Canada or has motivated franchisors to choose methods other than franchising to expand. Given the widely perceived and generally accepted benefits of franchising for distributing goods and services, significant legislative or regulatory changes should be a priority. In the meantime, practitioners preparing disclosure documents for use in Canada should proceed with extreme caution, a sound knowledge of both the legislative and judicial requirements for compliant disclosure, and adequate errors and omissions insurance.
APPENDIX A

Franchisor’s Associate Questionnaire

The Dollar It decision requires that certain information relative to a “Franchisor’s Associate” be contained in a franchisor’s disclosure document. For a more detailed discussion of the definition of Franchisor’s Associate, and the scope and type of information required to be disclosed relative to a Franchisor’s Associate, see the material contained in the body of this article.

The author believes that one can argue that the test used in the Dollar It decision to determine whether a person, corporation or other entity is a Franchisor’s Associate is flawed and over-reaching. However, it is what it is until a change in the law says otherwise.

If your client has a person, corporation, or other entity for which the answer to each of the following questions is “yes,” then the appropriate information about that individual or entity should be set out in the disclosure document and provided in the prescribed manner.

See the article above under the heading “What Needs to be Disclosed Relative to ‘Franchisor’s Associates’” for a discussion of possible additional required disclosure if you find that your system has one or more “Franchisor’s Associates:”

<table>
<thead>
<tr>
<th>Question</th>
<th>No</th>
<th>Yes</th>
</tr>
</thead>
<tbody>
<tr>
<td>1. Does your client’s organization have any other corporations (or other entity) involved in the operation of its franchise system?</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Examples include: supplier companies, entities providing financing, entities incorporated to hold real estate and sub-lease to franchisees, and holding companies for intellectual property and other assets</td>
<td></td>
<td></td>
</tr>
<tr>
<td>2. Do franchisees pay money (any amount) to that corporation?</td>
<td></td>
<td></td>
</tr>
<tr>
<td>3. Is there any kind of contract or any other form of agreement in place between your client’s franchisees and the affiliate corporation?</td>
<td></td>
<td></td>
</tr>
<tr>
<td>(Hint: If your answer to number 2 is “yes,” then the answer to this question will almost of necessity be yes; why else would the franchisee be paying money to the affiliate?)</td>
<td></td>
<td></td>
</tr>
</tbody>
</table>
APPENDIX B

The Dollar It Disclosure Document Checklist

Here is a checklist of the issues that the Ontario Court of Appeal found fatal to an otherwise satisfactory disclosure document.

If the answer to any of these questions has an asterisk * in the answer box, your client’s disclosure document and/or your compliance procedures need to be reviewed and updated.

<table>
<thead>
<tr>
<th>Question</th>
<th>No</th>
<th>Yes</th>
</tr>
</thead>
<tbody>
<tr>
<td>Are all Certificates of Disclosure attached to every Disclosure Document that your client provides to a prospect properly dated and signed by the appropriate person?</td>
<td>☐ *</td>
<td>☐</td>
</tr>
<tr>
<td>Does your client’s Disclosure Document include the franchisor’s current audited or review engagement financial statements?</td>
<td>☐ *</td>
<td>☐</td>
</tr>
<tr>
<td>If your client is providing “site-specific” disclosure, does your client’s Disclosure Document include a copy of the offer to lease or lease between the franchisee and the sublandlord, or the head lease for the property? Note: this obligation may also extend to other forms of agreements with affiliates of the franchisor, including supply agreements, intellectual property licensing, and financing.</td>
<td>☐ *</td>
<td>☐</td>
</tr>
<tr>
<td>Does an affiliate of the franchisor sublease the franchisee’s business premises to franchisees, or supply goods and services, or provide financing?</td>
<td>☐</td>
<td>☐ *</td>
</tr>
<tr>
<td>Is the disclosure in your client’s Disclosure Document relative to your client’s ad fund “detailed and specific” and does it clearly and concisely respond to all technical requirements of the Regulation, using negative disclosure where appropriate?</td>
<td>☐ *</td>
<td>☐</td>
</tr>
<tr>
<td>Does your client’s Disclosure Document include the description of the actual territory to be granted?</td>
<td>☐ *</td>
<td>☐</td>
</tr>
<tr>
<td>Does your client’s Disclosure Document include information on the franchisor’s policy on the proximity between franchisees?</td>
<td>☐ *</td>
<td>☐</td>
</tr>
<tr>
<td>Does your client’s Disclosure Document include a description of the license, registration, authorization or other permissions required to be obtained to operate the franchise?</td>
<td>☐ *</td>
<td>☐</td>
</tr>
<tr>
<td>Does your client’s disclosure document contain a description of its policy, if any, regarding volume rebates, and whether or not your client or its associate receives a rebate, commission, payment or other benefit as a result of purchases of goods and services by a franchisee and, if so, whether rebates, commissions, payments or other benefits are shared with franchisees, either directly or indirectly.</td>
<td>☐ *</td>
<td>☐</td>
</tr>
</tbody>
</table>

Note 1: This list of deficiencies should in no way be considered a complete checklist for the adequacy of your client’s disclosure document. Our current checklist is eight single-spaced pages. This list of nine items was merely what counsel for the franchisee was able to identify...
with hindsight. The Court of Appeal has suggested that the only kind of deficiency within a disclosure document that will not invalidate the document entirely is a “minor non-material detail.” And, of course, an accumulation of such minor non-material details might in the aggregate result in a finding of “non-disclosure” and permit a franchisee to rescind at any time within two years of the date he received your disclosure document.

**Note 2:** The *Dollar It* decision repeatedly stresses that, even if your client does not have a policy or practice required to be disclosed, *the absence* of such a policy or practice is then required to be disclosed and discussed.
Appendix C

Suggested Retainer Wording

Almost invariably in any action in which lawyer’s negligence is alleged, attention will turn to the scope—and any express or implied limitations—of the retainer. The author uses the wording below as a part of his firm’s retainer letter to be provided by any franchise system.

If we have prepared a franchise disclosure document for you, then we have relied entirely upon the information provided by you in the preparation of the document without independent investigation or verification. You agree to indemnify us in the event of any claim by your franchisees in the event that material facts were not disclosed by you, or in the event of other defects in your documentation not relating to our legal advice. PLEASE NOTE: franchise law in Canadian jurisdictions requires disclosure of all material facts, on an on-going basis. Accordingly, you must keep all such disclosure documents current at all times. In addition, you may be required to disclose additional information, or completely re-disclose with site-specific information, in some instances. The retainer created by this letter is strictly limited to providing advice and counsel to you in respect of matters about which our advice is sought. Advising you in respect of changes that you make to your documentation or disclosure practices, or with respect to changes in the law that occur after delivery of your disclosure documentation to you, are specifically excluded from the scope of this retainer.
Compliance Audits Rule!

Mary Beth Gettins

It is irrelevant how, when, and why franchise compliance audits are completed. Findings of a franchise compliance audit can be grounds for termination of the franchise agreement and a wide range of claims. It is immaterial if a compliance audit is done by sampling, onsite inspection, or comparative analysis. Pretext, discrimination, duress, waiver, and franchisor misconduct defenses will not rule over compliance audit findings. This article discusses these issues, and what court rulings have had to say about compliance audits.

I. How Are Compliance Audits Conducted?

There are many types of compliance audits. Typically, franchisors rely on traditional onsite inspections to check brand standards. Compliance audits that inspect brand standards include such things as reviewing how food items are prepared and staged. This entails checking equipment temperatures, employee practices, premise conditions, and cleanliness.

For example, franchisor Burger King Corporation completes Quality Compliance Standards (QSC) inspections, which includes inspecting equipment, food processing, holding and preparation, hygiene, and employee practices. Following the QSC inspections, the franchisee is given a score, which reflects any deviations from Burger King standards. Deviations noted in the QSC inspection must be corrected to a minimal level of acceptability within a reasonable time. Failure to correct the deviations in reasonable time is a material default of the franchise agreement.1 McDonald’s likewise completes QSC inspections that review food safety, equipment temperatures, and employee safety checklists. Results of the QSC inspection, if severe, may be a material default of the franchise agreement.2

In comparison, franchisors are relying on technology to inspect franchisee revenue reporting. Technology allows franchisors to identify potential red

2. McDonald’s Corp. v. Robertson, 147 F.3d 1301 (11th Cir. 1998).

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flags and to complete comprehensive compliance audits remotely from their headquarters. Revenue reporting compliance violations most commonly involve unreported or non-reported franchisee consumer sales.

For example, in one case, 7-Eleven initially identified a franchisee’s revenue inaccuracies using a point of sale (POS) comparative algorithm that ranked all stores within regional zones for high-risk transactions, such as item voids, non-scanned sales, canceled age verification, no sale, change makers, and penny sales. When the particular franchisee ranked first and second in several high-risk rankings, 7-Eleven engaged in further auditing and inspections using a comparative analysis of the franchise’s physical inventory, inventory purchases, and sales recording data generated via the POS. 7-Eleven also compared repeated secret shopper purchasers with POS sales reports. Finally, compliance officers watched the in-store security tapes.

Other franchisors also use comparative analyses, similar to the methods employed by 7-Eleven, of inventory purchases and sales records. For example, franchisor Noble Roman’s completed an almost ten-year audit from 2004 to 2014 of a franchisee’s inventory purchases compared to gross sales. Based on inaccuracies between purchases and reported sales, Noble Roman’s tendered a demand for underpayment under the franchise agreement. The franchisee refused to pay the alleged unpaid royalties and stopped offering Noble Roman’s services to customers.

II. When Are Compliance Audits Done?

The methods, means, and scope of compliance are expansive. When a franchise compliance audit is conducted is equally expansive. Compliance audits may be prompted by routine analysis and onsite visits, or they may be initiated based on consumer complaints or other specific events. The frequency of compliance audits is unfettered, and compliance audits may be announced or unannounced.

A. Illegal Activity

The event that gives rise to a compliance audit need not be proximate in time to the compliance audit itself. For example, two years after a franchisee’s temporary workers were arrested and discovered to be illegal aliens, franchisor Manpower completed an onsite inspection of the franchisee’s I-9 forms. The inspection revealed so many incomplete and missing I-9 forms for temporary

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4. Id.
5. Id. at 621.
6. Id. at 621–22.
8. Id.
9. Id.
workers that the auditor deemed the results of the inspection to be “the most egregious she had seen in her sixteen years at Manpower.” This inspection occurred nearly three years after Manpower wrote a letter to the franchisee in September 2001 reporting the franchisee’s numerous deficiencies:

- poor judgment as evidenced by expressing his disagreement about pricing policies with visiting Manpower personnel in front of a customer;
- dishonesty—a visiting Manpower employee observed franchisee’s son take and copy confidential materials from a competitor’s office located in a customer’s facility;
- repeatedly doing business outside the franchise’s territory;
- failing to follow directions and to cooperate with Manpower;
- making many unfounded complaints about Manpower;
- immaturity as evidenced by throwing tantrums and making vulgar remarks to female employees; and
- rudeness as evidenced by treating Manpower staff in a hostile manner.

In addition, there were ongoing territorial violations. The franchisee’s son actively advertised, solicited, and provided temporary workers beyond the franchisee’s territory, contrary to numerous conversations with the franchisor. The franchisee’s son also established a consulting firm, holding it out as a division of the Manpower. After the franchisee’s son engaged in some inappropriate behavior at a franchisee convention in 2004, Manpower decided to conduct the audit. Based on all of these findings (illegal conduct, territorial violations, misusing the franchisor’s name, etc.), Manpower sent the franchisee a letter on July 25, 2005, rescinding the Manpower franchise agreement.

B. Customer Complaints

Franchisors also conduct audits in response to customer complaints. For example, a customer contacted franchisor Aamco regarding a warranty compliant. The customer produced receipts evidencing work completed, but
the receipts were not Aamco receipts. This prompted an onsite compliance audit ten days later.19 During the onsite audit, the auditors discovered two non-Aamco receipt books.20 The franchisee refused to allow the auditors to inspect or copy the receipt books.21 In response to the franchisor’s demand to copy and inspect the receipt books, the franchisee’s attorney sent a letter stating that Aamco had no right to inspect the franchisee’s private records.22 Aamco filed a complaint seeking termination of the franchise agreement and monetary damages for breach of contract based on the franchisee’s failure to report and pay royalties as well as failure to allow inspection of books and records.23

C. Reacquisition of Franchise

Franchisors may also conduct audits when a location changes hands. For example, in another case, 7-Eleven completed a changeover audit of the physical inventory and reported sales following termination of a franchise agreement and reacquisition of the franchise.24 When the audit revealed several deficiencies, 7-Eleven filed a complaint against the former franchisee demanding monies owed based on claims of fraud.25 The court granted summary judgment in favor of 7-Eleven and entered a judgment against the former franchisee in the amount of $567,930.64.26

III. Franchisee Perspective On Compliance Audits

When confronted with the deficiencies found in compliance audits, franchisees frequently argue that the stated purpose for the compliance audit was a pretext and that the audit was in fact conducted for an undisclosed, improper purpose. Although franchisees often raise these claims in litigation, these protests are usually unsuccessful.

A. Forced Relocation

In a case of alleged pretextual compliance auditing, McDonald’s offered a franchisee the opportunity to relocate the franchise to a recently purchased McDonald’s-owned property one block away.27 When the franchisee declined relocation, McDonald’s offered to purchase the franchisee’s franchise.28 The franchisee again declined McDonald’s offer, and McDonald’s conducted a

19. Id.
20. Id. at 3.
21. Id.
22. Id.
23. Id.
25. Id. at 3.
26. Id.
27. McDonald’s Corp. v. Robertson, 147 F.3d 1301, 1304 (11th Cir. 1998).
28. Id. at 1305.
compliance audit two months later.\textsuperscript{29} McDonald’s had already completed an audit just days before it made the initial offer to relocate the franchise.\textsuperscript{30} In fact, McDonald’s had conducted many compliance audits of the franchisee over the preceding years, including ten unannounced audits and follow-up audits between February 1995 and August 1997.\textsuperscript{31} McDonald’s found deficiencies in all ten of the compliance audits. The franchisee alleged that McDonald’s took action to terminate the franchise agreement based on compliance audits only after franchisee’s rejection of offers to relocate and to sell the franchise.\textsuperscript{32} The Eleventh Circuit rejected this argument, noting that the deficiencies discovered in the compliance audits were sufficient to warrant termination of the franchise agreement, even if McDonald’s conducted the audits as a pretext after the franchisee refused to sell the franchise.\textsuperscript{33}

\section*{B. Exit from Inner City}

A Burger King franchisee likewise asserted a defense of pretext when Burger King terminated its franchise agreement based upon compliance audit deficiencies.\textsuperscript{34} Burger King’s new ownership allegedly no longer wanted Burger King restaurants in inner city areas.\textsuperscript{35} In addition, the franchisees contended that similar operating conditions had been tolerated in white-owned and operated franchises, that the new standards targeted minority operators, that the franchisee’s health and safety violations did not result in citation of violations of the health code, and that the compliance audit was conducted as retaliation for a class action against franchisor Burger King, in which the franchisee was a member.\textsuperscript{36} The court summarily rejected all the franchisee’s defenses because it was undisputed that the franchisee was not in compliance.\textsuperscript{37}

\section*{C. Racial Discrimination}

When a compliance audit revealed unrecorded revenues, 7-Eleven terminated the franchise agreement and filed a civil complaint against the franchisee.\textsuperscript{38} The franchisee had not paid royalties or sales tax on the unreported

\begin{footnotesize}
\begin{itemize}
\item \textsuperscript{29} Id.
\item \textsuperscript{30} Id. at 1304–05.
\item \textsuperscript{31} Id.
\item \textsuperscript{32} Id. at 1309.
\item \textsuperscript{33} Id. (“Even assuming, arguendo, that this allegation is correct, however, we find that the Robertsons’ failure to comply with McDonald’s QSC and food safety standards constituted a material breach of the franchise agreement sufficient to justify termination, and thus, it does not matter whether McDonald’s also possessed an ulterior, improper motive for terminating the Robertsons’ franchise agreement.”).
\item \textsuperscript{34} Burger King Corp. v. Stephens, CIV. A. No. 89–7691, 1989 WL 147557 (E.D. Pa. Dec. 6, 1989)
\item \textsuperscript{35} Id. at *5.
\item \textsuperscript{36} Id. at *11.
\item \textsuperscript{37} Id. at *13.
\item \textsuperscript{38} 7-Eleven, Inc. v. Sodhi, Civil Action No. 13-3715 (MAS) (JS), 2016 WL 3085897, at *3 (D.N.J. May 31, 2016).
\end{itemize}
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revenues. The court held that New Jersey Law Against Discrimination does not cover discrimination during the ongoing execution of the contract; therefore, the franchisee’s claims of discrimination failed as matter of law.

IV. What Courts Have To Say About Compliance Audits

If a material default of the franchise agreement is discovered during a compliance audit, courts have overwhelmingly ruled in favor of the franchisor. Franchisees rarely contest the franchisor’s ability to conduct audits, and courts rarely question franchisors’ right to inspect and complete compliance audits. Instead, courts focus on the franchisee’s duties and obligations as set forth in the franchise agreement, including the duty to follow brand standards and the duty to report revenues and pay royalties. When franchisees fail to do so, courts will side with the franchisor.

As previously discussed, a franchisor’s ulterior motive in conducting a compliance audit is no defense, and the same is true of acquiescence and waiver. For example, in response to being terminated for violations of McDonald’s health and safety deficiencies, one franchisee stated in an affidavit: “I became increasingly surprised by these findings, since I was operating my restaurant in the same manner and according to the same high standards for food, safety, and service that I had maintained for the past twenty-six years as a McDonald’s owner/operator.” The court was not persuaded. The franchisee had in fact been given notice of previous deficiencies discovered during compliance audits. Past unenforced breaches are no defense to

39. Id.
40. Id. at *7.
41. Id.
42. Dunkin’ Donuts Inc. v. Patel, 174 F. Supp. 2d 202 (D.N.J. 2001) (“Defendants [franchisees] are required to maintain their shops in compliance with Plaintiff’s standards, including those standards for health, sanitation, and safety.”); 7-Eleven, Inc. v. Upadhyaya, 926 F. Supp. 2d 614 (E.D. Pa. 2013) (“The Franchise Agreement provides that Milind, Minaxi, and Enterprises [franchisees] were required to, inter alia, use electronic equipment to scan all products which can be scanned, report all sales to 7-Eleven, and otherwise provide 7-Eleven with truthful, accurate, and complete information regarding the operation of the store.”).
44. This is particularly true where unpaid royalties and sales tax are discovered. This is best illustrated in a recent case involving 7-Eleven in which the court summarized the issue as follows:

The Court finds that Mr. Sodhi’s [7-Eleven franchisee] failure to pay and/or withhold applicable payroll and income taxes, in addition to being against the law, is a material breach of the Franchise Agreements. Thus, any purported ulterior motive of 7-Eleven, even if shown, is irrelevant to finding that 7-Eleven had good cause to terminate the Franchise Agreements. Thus, construing the facts in the light most favorable to Defendants, no reasonable juror could find that 7-Eleven did not have good cause to terminate the Franchise Agreements.

Id. (citations omitted).
45. McDonald’s Corp. v. Robertson, 147 F.3d 1301, 1308 (11th Cir. 1998).
46. Id.
current material breaches of the franchise agreement. McDonald’s was free to change its health and safety standards and free to change its practices of enforcement.

In cases where material defaults uncovered in compliance audits are in the realm of criminal wrongdoing, a criminal conviction is not required. If the franchise agreement requires compliance with the law, a simple showing that franchisee failed to follow the law is sufficient. Further, even if the criminal wrongdoing is corrected, that does not erase the fact that the franchisee committed a crime. Accordingly, the crime can still form the basis of a material breach of the franchise agreement.

Similarly, it does not follow that violations of the franchisor’s standards are a material default only if they are a violation of state or local health and safety regulations. “[A] franchiser is free to establish health, sanitation, and safety standards that exceed those of the municipality in which the franchised store is located.” If the franchisee does not follow the franchise standards, it is in default under the franchise agreement, irrespective of what the law requires.

V. Conclusion

A franchisor’s right to inspect and audit is unfettered. Courts repeatedly rule that following brand standards, reporting revenues, and paying royalties goes to the core of the franchise relationship. Failure to follow the franchisor’s brand standards irreparably harms the goodwill of the franchisor and the franchise system. This sentiment is articulated by the court in this way:

The public’s knowledge of the uniformity of operation and quality of product draws business to Burger King restaurants. Therefore, the name “Burger King” constitutes a trademark of great value to BKC and to the franchisees. BKC’s inability to protect and insure the maintenance of the high quality of service that the marks represent would cause irreparable injury to BKC’s business reputation and goodwill.

Courts find that a franchisee’s failure to report revenues and pay royalties is not only a breach of the franchise agreement but also fraud that goes to the heart of the trust in the franchise relationship. The court in the Upadhyaya case explained it this way:

The Court thus concludes that 7-Eleven has proven all elements of fraud by clear and convincing evidence and that the fraudulent actions of the defendants constituted a breach going to the essence of the contract. Defendants’ fraudulent actions

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47. Id.
49. Id.
50. Id. at 4.
51. Id.
served to destroy all trust between themselves and 7-Eleven, and the Court finds that requiring notice before termination under such circumstances would be a useless gesture, as such a breach may not reasonably be cured. Consequently, the September 28, 2012 termination of the Franchise Agreement without any notice or opportunity to cure was proper, and the Agreement was terminated as of that date.⁵⁴

Practitioners should know that courts look to intangibles. Courts will consider brand goodwill, harm to public reputation, and the trust between the franchisor and franchisee when determining whether a franchise compliance audit is sufficient grounds for termination of the franchise relationship.⁵⁵

⁵⁵. As previously discussed, the case law discusses primarily egregious compliance violations. But what is the outcome with lesser compliance violations? What rises to the level of harming goodwill, public reputations, and the trust between the franchisor and franchisee? Although there is no bright line articulated in the case law, it appears that courts place a high value on the express terms of the franchise agreement and the core trust in the franchise relationship.
Franchising (& Distribution) Currents

C. Griffith Towle, Jan S. Gilbert, and Elliot R. Ginsburg

ANTITRUST


A Chrysler, Jeep, Dodge, and Ram (CJDR) dealer (Stevens Creek) filed a complaint against Chrysler Group LLC in the U.S. District Court for the Northern District of California, asserting several claims, including a claim for price discrimination under the Robinson-Patman Price Discrimination Act, 15 U.S.C. § 13 (RPA or Robinson-Patman). The claims arose out of a dispute regarding a “Volume Growth Program,” which provides incentives to dealers if they meet monthly sales objectives.

Stevens Creek was a long-time CJDR dealer in San Jose, California, and the largest such dealer in Northern California. In 2012, a new CJDR dealer (Fremont) entered the marketplace in close proximity to Stevens Creek’s dealership. Stevens Creek claimed that Chrysler violated the Robinson-Patman by discriminating against Stevens Creek in the manner in which Chrysler set Stevens Creek’s monthly sales objectives to qualify for the incentive payments under the Volume Discount Program. As an existing dealer, Stevens Creek’s sales objectives were based on a formula pegged to its prior year’s sales plus a projected percentage increase in sales. As a new dealer with no prior sales, Fremont’s sales objectives were based on its projected sales. Stevens Creek claimed that its sales objectives should have been reduced because the two dealerships were only fourteen miles apart and Steven Creek’s sales objectives were based on a period of time in which there was no competition from Fremont.

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After a seven-day trial on the RPA claim, the jury returned a verdict in favor of Chrysler, finding that Stevens Creek had not proved price discrimination by a preponderance of the evidence. Stevens Creek filed a motion for new trial, challenging a jury instruction and a verdict form question regarding the judicially created “functional availability” doctrine. Under this doctrine, a plaintiff cannot recover damages for more favorable prices paid by a competitor if those same prices “were available to the plaintiff from a practical standpoint and on equal terms with its competitors.” Stevens Creek advanced three arguments in its post-trial motion: (1) the jury instruction and verdict form improperly assigned the “full burden of proof” on this issue to Stevens Creek, (2) the jury instruction did not properly set forth the elements of functional availability, and (3) the jury instruction and verdict form were confusing because they “togg[ed] between concepts of ‘functional availability’ and ‘functional unavailability.’”

As to its first argument, Steven Creek contended that the doctrine of functional availability is an affirmative defense and, therefore, a defendant must prove the favorable prices were functionally available to the plaintiff. Chrysler argued that because functional availability negates two elements of an RPA claim—price discrimination and competitive injury—it is a plaintiff’s burden to address this issue. As an initial matter, the court noted there was no binding authority in the Ninth Circuit and the model jury instructions do not address the issue. Given this, the court started its analysis by first addressing the basics regarding affirmative defenses, holding that an affirmative defense “raises new facts and arguments” that defeat a plaintiff’s claim, even if the plaintiff establishes all of the elements of such claim; whereas, a defense that simply identifies a “defect in the plaintiff’s prima facie case is not an affirmative defense.” Relying on a number of decisions from various circuit courts, the court held that because the functional availability doctrine “negates” two of the elements of a price discrimination claim, it was not an affirmative defense.

The court was equally unpersuaded by Stevens Creek’s alternative argument that even if functional availability negated an element of its price discrimination claim, the burden would shift to the defendant to prove “the discounts were justified” once a plaintiff established the elements of an RPA claim. As support for this burden-shifting argument, Stevens Creek relied on a Sixth Circuit case involving a motion for summary judgment on a price discrimination claim. The court found this case to be inapposite because the burden-shifting scheme on a motion for summary judgment with respect to a claim or issue as to which the defendant does not bear the burden of proof is of a “different sort” and does not apply to the burden of proof at trial. The court further found, without explanation, that even if the burden should not have been assigned to Stevens Creek, it was harmless error.

The court then turned to Stevens Creek’s argument that the jury instruction misstated the elements of functional availability. Stevens Creek contended that the jury instruction was defective because it did not state that the incentives must be available “on an equal basis” and instead only stated
that the objectives must have been practically available if Stevens Creek had engaged in commercially reasonable efforts to achieve them. Chrysler argued that it was not necessary to instruct the jury on the issue of evenhandedness because a discount that is practically attainable is functionally available “because a buyer acting in a commercially reasonable manner would earn it,” and that even if evenhandedness was required, Stevens Creek had not challenged the evenhandedness of the Volume Discount Program.

Again there was no binding authority on this question. However, the court found that the recently published ABA Model Jury Instructions, which state that the functional availability defense “only applies when the lower price was known to and obtainable by most competing purchasers,” provided some guidance. Notwithstanding, because the court found this to be persuasive, but not “dispositive,” it engaged in a thorough review of a number of cases. Based on this review, the court concluded that functional availability does not have two elements (i.e., “practical attainability” and “evenhandedness”), but rather is a “concept that can be captured in multiple ways,” including references to either or both practical availability and evenhandedness. Accordingly, the court was persuaded that the jury instruction was an accurate statement of the law, albeit not as detailed as Stevens Creek wanted.

The court also noted that Stevens Creek had failed to explain what needs to be “evenhanded” for the Volume Discount Program to be functionally available and that its real complaint was that its sales objectives were higher than those set for Fremont. However, the court held that evenhandedness does not require that the objectives be equal, but rather that there be objective standards “to guide the dealers in qualifying for the [program] and that the standard for each dealer is similar, or on ‘equal terms.’”

Finally, the court turned to Stevens Creek’s argument that the jury instruction and verdict form question regarding functional availability were confusing because they referred to both “functional availability” and “functional unavailability.” The court first noted that Stevens Creek had waived this argument because it had not originally objected to the instruction and verdict form. The court nonetheless considered Stevens Creek’s arguments, but found them to be meritless because the jury had not expressed any confusion, “expressing a negative in an alternative way is unlikely to cause confusion,” and other courts had used the identical language in describing the functional availability doctrine.

ARBITRATION


The U.S. District Court for the Northern District of Texas denied Charging Bison, LLC’s motion to stay an arbitration with its franchisor Interstate Battery Franchising & Development, Inc.
Charging Bison entered into a franchise agreement with Interstate Battery pursuant to which it acquired the rights to operate an Interstate Battery franchise in Cheyenne, Wyoming. The franchise agreement provided that “any claim or controversy between the parties . . . arising out of or related to this Agreement, the relationship between Franchisor and Franchisee, or Franchisee’s operation of the franchised business shall be submitted to arbitration” conducted by JAMS. However, the franchise agreement also provided that “any claim or dispute involving the propriety of any termination of this Agreement” was not subject to arbitration.

Several years after entering into the franchise agreement, Charging Bison allegedly discovered that the FDD “contained materially misleading statements, skewed figures, and misrepresentations of the financial strength and revenues” of Interstate Battery’s franchisees. The parties disagreed whether Charging Bison, which continued to operate its Interstate Battery business, was entitled to terminate the franchise agreement on the basis of the claimed misrepresentations in the FDD and on other grounds, and whether their dispute was subject to arbitration.

Interstate Battery filed a demand for arbitration with JAMS seeking, among other things, a declaration that there were no grounds for Charging Bison to terminate the franchise agreement. Charging Bison filed objections with JAMS, contending that claims involving the propriety of any termination of the franchise agreement were excluded from the arbitration requirement. Interstate Battery, on the other hand, argued that the carve-out was limited to whether a decision to actually terminate the franchise agreement was proper. JAMS denied Charging Bison’s objections and refused to stay the arbitration.

Charging Bison subsequently filed a lawsuit in Texas state court seeking a determination on whether it was entitled to terminate the franchise agreement and to stay the pending JAMS arbitration. Interstate Battery removed the matter to federal court, and the court addressed Charging Bison’s motion to stay.

The issue before the court was whether Charging Bison’s claim for a declaration that it was entitled to terminate the franchise agreement fell within the exception to arbitration set forth in the agreement. Interstate Battery argued that it did not because the franchise agreement had not been terminated and, therefore, the “propriety of an actual termination [was] not at issue.” Interstate Battery further argued that the parties’ dispute over whether Charging Bison was fraudulently induced into signing the franchise agreement was covered by the arbitration clause because it arose out of and related to the parties’ relationship and agreement.

As an initial matter, the court noted there is a strong public policy favoring arbitration and arbitration was mandatory “on issues as to which the arbitration agreement was signed” under the Federal Arbitration Act. With respect to the gateway issue of whether the parties’ dispute was subject to arbitration, the court observed that such determination was for the court un-
less the parties’ agreement “clearly and unmistakably provide otherwise.” Relying on JAMS Rule 11(b), which provides that “the arbitrator has the authority to determine . . . arbitrability issues as a preliminary matter,” Interstate Battery argued that the parties had delegated the arbitrability issue to JAMS. Notwithstanding the seeming clarity of the JAMS Rule, the court elected to address the arbitrability issue as requested by Charging Bison.

Before addressing the arbitrability issue, the court held that Supreme Court precedent mandates that any doubts concerning the scope of the arbitration clause be “resolved in favor of arbitration.” With this backdrop, the court made quick work of the arbitrability issue, finding that the “plain meaning” of the arbitration provision did not “cover anticipatory terminations of the franchise agreement;” therefore, the court denied Charging Bison’s motion to stay the JAMS proceeding.


This case arose out of a dispute between the franchisor of Subway restaurants, Doctor’s Associates Inc. (DAI), and related entities and a former Subway franchisee in Wisconsin (Repins). The U.S. District Court for the District of Connecticut granted DAI’s petition to compel arbitration, but denied DAI’s motion to permanently enjoin Repins from pursuing its claims in a non-arbitral forum.

Subway Real Estate, LLC (SRE), an affiliate of DAI, filed an action in Wisconsin state court seeking a judgment of eviction against Repins (Wisconsin lawsuit). In the Wisconsin lawsuit, Repins asserted various affirmative defenses and claims, including that DAI was an indispensable party that must be joined in the Wisconsin lawsuit and that SRE had waived the arbitration provision in various agreements among DAI, SRE, and Repins by filing the Wisconsin lawsuit. Repins subsequently advised DAI that it intended to add DAI to the Wisconsin lawsuit. In response, DAI filed a lawsuit in the U.S. District Court for the District of Connecticut seeking to compel arbitration (the first federal lawsuit). Repins then advised that it had not decided whether to join DAI in the Wisconsin lawsuit. Based on this representation, DAI dismissed the first federal lawsuit.

Repins subsequently filed a pleading in the Wisconsin lawsuit identifying witnesses who would testify as to topics involving both SRE and DAI, as well as the damages it was seeking to recover, including $60,000 from the “lost sale” of its business, $300,000–$450,000 in lost future profits, and $155,000 in losses associated with improvements to the leased location. As a result, DAI filed another lawsuit in the U.S. District Court for the District of Connecticut, as well as a petition to compel arbitration and a motion for permanent injunction.

The district court first addressed Repins’ argument that the amount in controversy requirement for diversity jurisdiction was not met because:
(1) the amount of rent that it allegedly owed SRE was less than $75,000, (2) it was allegedly on the verge of bankruptcy, and (3) it would “probably not be able to prove much more than $50,000” in damages. The court rejected the first argument because the relevant amount at issue was the damages that Repins was seeking to recover. The court also rejected Repins’ second argument, noting there was no “connection” between Repins’ potential bankruptcy and the amount Repins was seeking to recover in the Wisconsin lawsuit. As to Repins’ third argument, the court expressed concern that Repins was being disingenuous in the Wisconsin lawsuit as to the amount at issue or with the court. The court ultimately found that Repins had failed to provide any support for its claim that it would probably not be able to recover more than $50,000.

The court then turned to DAI’s petition to compel arbitration. Repins argued that the arbitration provision was unconscionable and any arbitration should occur in Wisconsin and not the designated arbitral forum (Connecticut). The court acknowledged that these arguments implicated gateway issues of arbitrability, but held that the arbitration provision clearly and unmistakably delegated the questions of arbitrability to the arbitrator. Repins also argued that there were no pending claims against DAI that would be subject to arbitration. The court found that this argument was also for the arbitrator to address, but noted that even though DAI was not currently named as a party in the Wisconsin lawsuit, the counterclaims asserted by Repins against SRE appeared to be covered by the arbitration provision in the franchise agreement. The court likewise declined to address Repins’ waiver, laches, and good faith arguments, holding that such arguments were properly decided by the arbitrator.

The court next considered and denied DAI’s request that Repins be ordered to pay DAI’s fees and costs in compelling arbitration, finding that it was premature. In particular, the initial questions of whether the arbitration provision was enforceable and applicable to the claims being asserted by Repins needed to first be decided by the arbitrator before the court could decide if DAI was entitled to recover its fees and costs.

Finally, the court addressed DAI’s request that Repins be permanently enjoined from prosecuting any claims that Repins had asserted or could have asserted in the Wisconsin lawsuit. The court denied DAI’s request, finding that DAI had not satisfied the four-factor test for injunctive relief and that it ran afoul of the Anti-Injunction Act, which prohibits a federal court from enjoining a state court proceeding “except as expressly authorized by the Act of Congress, or where necessary in aid of its jurisdiction, or to protect or effectuate its judgments.” The court found DAI had failed to establish that the balance of hardship between DAI and Repins warranted “a remedy in equity” and that “the public interest would not be disserviced” by the requested permanent injunction. The court further found that it would be premature to permanently enjoin Repins from pursuing its claims because the arbitrator had not yet ad-
dressed whether the arbitration provision was enforceable and whether Repins’ claims were subject to arbitration. Lastly, the court distinguished several cases from the Second Circuit in which a party was permanently enjoined from taking certain action in a state court proceeding.


The U.S. District Court for the Northern District of California declined to vacate an arbitration award stemming from a dispute regarding the termination of the plaintiffs’ franchise agreement with Jiffy Lube International, Inc. (JLI).

The franchise agreement was terminated in June 2013, and the plaintiffs filed an action against JLI in California state court on February 26, 2015. JLI removed the case to federal court and filed a petition to compel arbitration. The parties ultimately stipulated to arbitration and the federal lawsuit was dismissed on September 3, 2015. As part of the stipulation, JLI agreed to waive the two-year contractual statute of limitations with respect to the claims asserted in the complaint, but not as to “any other rights regarding limitations,” provided the plaintiffs commenced the arbitration within one month of the dismissal of the federal court case.

The plaintiffs submitted a demand for arbitration on September 30, 2015, and a Statement of Claim on October 26, 2015. The plaintiffs subsequently filed an Amended Statement of Claim on February 3, 2016, and a Second Amended Statement of Claim on May 16, 2016, which added a claim that JLI violated the California Franchise Relations Act (CFRA). The arbitrator ultimately ruled in JLI’s favor, and the plaintiffs filed a motion to vacate the arbitrator’s ruling that the CFRA claim was barred by the applicable statute of limitations.

The essential facts involved the lease for the location of the plaintiffs’ franchised business. JLI leased the premises from a third party and, in turn, subleased the premises to the plaintiffs. By its terms, the lease expired on June 18, 2013, several years before the expiration of the franchise agreement. The plaintiffs knew at the time they entered into the franchise agreement that the lease expired before the expiration of the agreement. In January 2013, approximately six months before the end of the lease term, JLI advised the plaintiffs that it would not seek to enter into a new lease for the premises and that the plaintiffs would need to execute a direct lease with the owner if they wanted to continue to operate the franchised business at that location. The plaintiffs entered into discussions with the owner, but were unsuccessful in negotiating a new lease. Shortly after the lease terminated, JLI advised the plaintiffs they were in default of the franchise agreement because they had lost the right of possession and that such default was non-curable. Accordingly, the franchise agreement was terminated effective as of June 30, 2013.
The arbitrator found that JLI violated Section 20020 of the CFRA in terminating the franchise agreement without providing an opportunity to cure. However, the arbitrator also found that such claim was barred by the two-year statute of limitations set forth in the franchise agreement because the claim was asserted for the first time in the Second Amended Statement of Claim filed in May 2016.

In addressing the plaintiffs’ motion to vacate, the court considered, without deciding, JLI’s claim that the motion was untimely because it was not filed within three months of when the arbitration award was served. Pursuant to Section 12 of the Federal Arbitration Act (FAA), a motion to vacate “must be served . . . within three months after the award is filed or delivered.” Here, the arbitrator’s award was sent to the parties on September 14, 2016, and the plaintiffs filed their motion to vacate on December 15, 2016. The plaintiffs argued that because the FAA does not specify a method of computing time, Federal Rule of Civil Procedure 6(a) applied, which provides that the day of the event that triggers the period is excluded for purposes of calculating the time. The court noted there was conflicting authority regarding this issue, but declined to decide the matter.

The court then turned to the plaintiffs’ contentions that the arbitrator manifestly disregarded the law or that his decision was “completely irrational” because the doctrines of equitable tolling and relationship back applied and, therefore, the CFRA claim was not time-barred. The court disagreed. The court held that even if the plaintiffs were correct that the equitable tolling and relationship back doctrines saved the claim, more than a “mere error in the law or failure on the part of the arbitrator[] to understand and apply the law” was required to overturn the arbitrator’s ruling. Instead, the arbitrator must have must been both aware of the law and chosen to “intentionally disregard it.” The court found there was no evidence the arbitrator knew or was aware of the law and rejected the plaintiffs’ argument that the arbitrator had somehow prevented them from addressing the issue at the arbitration. The court noted that the arbitrator permitted the plaintiffs to add their CFRA claim, but expressly withheld making any ruling on whether it was barred by the statute of limitations. The court further noted that the plaintiffs specifically addressed the statute of limitations issue in their pre-hearing brief and two post-hearing briefs, but did not argue that the statute of limitations was equitably tolled or that the CFRA claim related back to the initial complaint.

The U.S. District Court for the District of South Carolina denied a pizza franchisor’s motion to dismiss a franchisee’s complaint for lack of personal
jurisdiction after determining that the parties had not signed a franchise agreement requiring them to arbitrate their disputes.

Integrity Brands, LLC is the Georgia-based franchisor of Uncle Maddio’s Pizza Joint franchises. In April 2012, Integrity Brands and Thea and Theo’s, LLC (T&T) entered into a market development agreement for the establishment of multiple pizza restaurants. The market development agreement contained a dispute resolution provision requiring arbitration in Georgia. Pursuant to the market development agreement, T&T would enter into a separate franchise agreement prior to opening and operating each pizza restaurant. T&T’s owners also established a separate company, Theo’s Pizza, LLC, which began operating an Uncle Maddio’s Pizza Joint franchise in South Carolina. Theo’s did not, however, sign a separate franchise agreement with Integrity Brands for the establishment of the South Carolina restaurant.

In March 2014, Theo’s sent an email to Integrity Brands noting that Integrity Brands had broached the topic of the parties signing a franchise agreement on several occasions. In that email, Theo’s stated that it could not execute any agreement that, among other things, was one-sided to Integrity Brand’s benefit. Theo’s attached to the e-mail a copy of a draft amended franchise agreement that eliminated a requirement that the parties arbitrate certain disputes. The parties did not, however, execute the form of amended franchise agreement proffered by Theo’s.

Theo’s subsequently sued Integrity Brands in South Carolina state court for violation of the state Business Opportunity Sales Act, declaratory judgment and, in the alternative, breach of contract. Integrity Brands removed the case to the district court on the basis of diversity jurisdiction and then moved to dismiss the case for lack of personal jurisdiction under Federal Rule of Civil Procedure 12(b). Integrity Brands argued that Theo’s claims were directly related to the market development agreement and, as such, were subject to binding arbitration.

Noting that the Fourth Circuit has held that to compel arbitration, a party must demonstrate: (1) the existence of a dispute between parties; (2) a written contract that includes an arbitration provision purporting to cover the dispute; (3) the relationship of the transaction to interstate or foreign commerce pursuant to the underlying agreement; and (4) the failure, neglect, or refusal of the other party to arbitrate the dispute, the court stated that neither party had provided evidence that the other had accepted either the original or proposed amended franchise agreement. Dismissing Integrity Brands’ argument that it would be impossible for Theo’s to operate a restaurant without the permission of Integrity Brands and T&T, the court held that the record was bereft of a signed contract or any other agreement by Theo’s to submit the dispute to arbitration.

Accordingly, noting that Theo’s had continued to operate the restaurant, the court declined to impute an agreement to Theo’s and denied Integrity Brands’ motion to dismiss for lack of personal jurisdiction.
In a case involving contractual breach and fraud claims, the U.S. District Court for the Northern District of Illinois denied cross-motions for summary judgment filed by a pizza and Italian-style sub sandwich franchisor and its franchisee so that the parties could address the threshold issue of whether a company that subsequently operated the franchised businesses must be joined as a necessary party to the case.

In March 2010, Noble Roman’s, Inc. and B&MP, LLC entered into two franchise agreements granting B&MP the right to operate a Noble Roman’s pizza restaurant and an Italian-style sub sandwich shop in a convenience store and gas station located in Bloomingdale, Illinois. The franchise agreements required B&MP to comply with all of Noble Roman’s standards and specifications relating to the operation of the franchised businesses and to use and sell only those designated products and ingredients that conformed to Noble Roman’s standards and specifications. The franchise agreements stated that they were to be interpreted and construed under Indiana law.

In August 2010, Leslie and Bradley Perdriau, B&MP’s owners, established a company called Army Trail Shell Deli, Inc. In September 2010, the gas station opened and began operating the Noble Roman’s restaurants. The Perdriaus claimed that Army Trail assumed B&MP’s obligations as a franchisee and became B&MP’s successor in interest to the station as of January 2011. In April 2012, B&MP was involuntarily dissolved by the Illinois Secretary of State.

In 2014, Noble Roman’s audited the restaurants and discovered, among other things, that the station had failed to purchase cheese and pepperoni specified by Noble Roman’s. Noble Roman’s also discovered that the franchisee had underreported its gross sales and underpaid royalties. The franchisee prematurely closed its Noble Roman’s restaurants in May 2014.

Noble Roman’s sued B&MP and the Perdriaus, alleging four claims: (1) breach of contract for the sale of nonconforming pizzas and subs and for underreporting gross sales; (2) violation of the Lanham Act for B&MP’s sale and distribution of unapproved pizza products and subs using Noble Roman’s marks without Noble Roman’s authorization or consent, likely causing confusion or deceiving customers; (3) deception in violation of Indiana law for B&MP’s misapplication of property in a manner that B&MP knew was unlawful; and (4) injunctive relief against B&MP and the Perdriaus to prevent them from violating Noble Roman’s trademark rights and the franchise agreements’ post-termination covenants. Although the matter was originally filed in the U.S. District Court for the Southern District of Indiana, it was transferred under the venue provisions of 28 U.S.C. § 1404.
Noble Roman’s moved for summary judgment on three issues, seeking rulings that (1) Noble Roman’s method of audit was permitted by the franchise agreements, IRS recommendations, and industry practice; (2) once the amount of an underpayment is determined, it is due and payable immediately by the underreporting party; and (3) B&MP breached the franchise agreements when it terminated them early and ceased to report sales and pay royalties after January 2014, entitling Noble Roman’s to recover future fees and other amounts. B&MP and the Perdriaus cross-moved for summary judgment on each of Noble Roman’s claims. The defendants claimed, among other things, that they were entitled to summary judgment because Illinois law, not Indiana law, governed the franchise agreements, and there was substantial evidence that B&MP assigned the franchise agreements to Army Trail and that Noble Roman’s accepted the assignment.

The court determined that Indiana’s choice of law rules applied due to long-standing precedent that when a case is transferred from another district, the court applies the choice of law rules that the court in the transferring state would apply. Here, because the case was transferred from Indiana, Indiana’s choice of law rules applied to Noble Roman’s state law claims. The court observed that Indiana choice of law provisions generally favor contractual stipulations regarding governing law. The parties’ underlying franchise agreements provided that they were to be interpreted and construed under Indiana law. Accordingly, the court applied Indiana law to the breach of contract claims. It rejected the defendants’ argument that the choice of law provision in the franchise agreements was not controlling due to language in the Illinois addendum to the disclosure document. The court observed that the Illinois addendum did not contain any language evidencing an intent that Illinois law govern all of the parties’ claims under the franchise agreements. Instead, it simply preserved additional rights and remedies that an Illinois franchisee might have under Illinois law.

Similarly, the court rejected the defendants’ argument that Noble Roman’s deception claim should be dismissed because Illinois law governed. Instead, it questioned the appropriateness of such a claim where the complaint was bereft of alleged facts to support it.

Finally, the court noted that the parties had glossed over the threshold matter of whether Army Trail was a necessary party to the case. The defendants argued that Army Trail assumed all of B&MP’s rights and obligations in 2011 and, therefore, was the only entity that could be responsible for B&MP’s debts and obligations. Noble Roman’s claimed that Army Trail was simply the business name that B&MP had been using since the parties began their contractual relationship and did not name Army Trail as a defendant or identify it as a d/b/a in the underlying complaint. Noting that the matter may be an appropriate case to pierce the corporate veil between B&MP and Army Trail, the court denied both motions for summary judgment without prejudice to allow the parties to brief the issue of whether Army Trail was a necessary party to the case.
CONTRACT ISSUES


The U.S. District Court for the Southern District of New York granted in part and denied in part a summary judgment motion filed by plaintiff Ford Motor Credit Co. LLC on its claims for breach of contract and fraudulent transfer, and denied a summary judgment motion filed by defendants Anthony Orton-Bruce, Sr., his ex-wife Victoria Orton-Bruce, and his current wife Renee Orton-Bruce. The court held that Ford was entitled to summary judgment on its breach of contract claim, but that genuine issues of triable fact remained on Ford’s fraudulent transfer claim.

Orton-Bruce, Sr. owned Monroe Motors, Inc., a Ford motor vehicle dealership. In September 1990, Monroe and Ford signed a wholesale financing and security agreement pursuant to which Monroe financed the purchase of new and used vehicles through advances and agreed to repay the advances to Ford as vehicles were sold. Orton-Bruce, Sr. signed a continuing guaranty with Ford. The continuing guaranty provided that Orton-Bruce, Sr. jointly, severally, and unconditionally guaranteed to Ford that Monroe would fully, promptly, and faithfully perform, pay, and discharge all of Monroe’s present and future obligations to Ford. It also stated that Orton-Bruce, Sr. would pay on demand all sums due and to become due to Ford from Monroe and all of Ford’s losses, costs, attorney fees, or expenses. The terms of the continuing guaranty provided that it could only be terminated by notice sent to Ford. Orton-Bruce, Sr.’s then wife, Victoria Orton-Bruce, signed an identical form of continuing guaranty.

In 2006, Orton-Bruce, Sr. sold his interest in Monroe to his son (Orton-Bruce, Jr.) and Orton-Bruce, Jr. signed a continuing guaranty with Ford. Neither Orton-Bruce, Sr. nor Victoria Orton-Bruce sent a notice to Ford terminating the continuing guaranties they previously signed. Subsequently, Ford discovered that Monroe breached the wholesale agreement by selling forty-five vehicles without repaying Ford. Ford requested payment from Orton-Bruce, Jr., but two attempted electronic transfer payments were returned for insufficient funds. When asked by a Ford representative whether he could pay the amount owed by Monroe, Orton-Bruce, Jr. replied that he could not.

Ford subsequently sent notice and demand letters to Orton-Bruce, Jr., Orton-Bruce, Sr., and Victoria Orton-Bruce regarding Monroe’s breach of the wholesale agreement, seeking payment in the amount of $889,885.09. Orton-Bruce responded by admitting to Ford that he understood that by virtue of the sale of Monroe to his son, he was not liable for any defaults by Monroe and the continuing guaranty was no longer Orton-Bruce, Sr.’s obligation. Orton-Bruce, Sr. also claimed that he did not discuss Monroe’s financial issues with his son after the sale of the dealership. Several months
later, Orton-Bruce, Sr. transferred to his new wife, Renee Orton-Bruce, his
interest in a home they had purchased together four years earlier for $2.1 mil-
ion. The transfer price was $1.00.

Ford filed a complaint alleging breach of contract by the defendants and
fraudulent transfer by Orton-Bruce, Sr. and Renee Orton-Bruce. Both par-
ties moved for summary judgment. The parties did not dispute the facts that:
(1) there was an existing contract between Ford and Monroe; (2) Monroe
breached the contract by failing to pay amounts owed to Ford pursuant to
the wholesale agreement; and (3) Ford was damaged as a result of the breach.
The court had to determine whether the continuing guaranties signed by
Orton-Bruce, Sr. and Victoria Orton-Bruce survived the sale of Monroe
to Orton-Bruce, Jr. and, if so, whether the defendants breached the contin-
uing guaranties.

The court rejected the defendants’ argument that the change in owner-
ship of Monroe terminated the continuing guaranties and found Orton-
Bruce, Sr. and Victoria Orton-Bruce liable to Ford for Monroe’s default.
Citing existing precedent, the court observed that: (1) a guaranty is a sepa-
rate, independent contract between the guarantor and the creditor; and
(2) a guaranty is collateral to the contractual obligation between the creditor
and the principal debtor. The court noted that a guaranty is not automati-
cally terminated by a change in the parties’ relationship. Where, as here,
the continuing guaranty had language of a “continuing obligation,” the guar-
anty was enforceable. The court considered the various circumstances
through which changes in the structure or formation of the principal debtor
may release the guarantor from his guaranty obligations. Under New York
common law, the inquiry is whether the changes in the entity whose debts
or responsibilities are guaranteed have the effect of creating a principal
with a new identity whose debts the guarantor never intended to guarantee.
Factors to consider in determining whether the principal debtor has survived
are changes in the business name, form, composition, management, owner-
ship, or involvement of the guarantor in the changes to the business. The
court determined that even though Monroe’s ownership changed following
the sale of the dealership from Orton-Bruce, Sr. to Orton-Bruce, Jr., the
business name did not change and Orton-Bruce, Sr. participated in the
changes. The court noted an admission by the defendants that Orton-
Bruce, Sr. did consulting work for Monroe after the sale and until 2007.

The court found persuasive a 1995 case involving Ford and another guar-
antor who had signed a guaranty with an identical termination provision. In
that case, Ford had obtained a judgment against the guarantor twelve years
after the parties executed the original guaranty. Here, the court observed
that the defendants could have simply served written termination notice
upon Ford pursuant to the terms of the continuing guaranties to extinguish
their obligations, but failed to do so. It also rejected the defendants’ argument
that the divorce decree between Orton-Bruce, Sr. and Victoria Orton-Bruce
providing that Victoria was fully divested of any ownership in Monroe could affect the guaranty signed with Ford.

Ford also sought to set aside the transfer of the home between Orton-Bruce, Sr. and Renee Orton-Bruce as a fraudulent transfer. The defendants argued that the transfer was made for estate planning purposes and that it was done before Orton-Bruce, Sr. discovered he may be responsible for Monroe’s debt to Ford. Citing precedent under New York law that a court may consider certain “badges of fraud” where direct evidence of fraud is not readily apparent, the court observed that the timing of the transfer of property between Orton-Bruce, Sr. and Renee Orton-Bruce was suspicious. However, because the defendants argued that Orton-Bruce, Sr. always considered the continuing guaranty to be terminated as a result of the sale of Monroe and Ford failed to provide evidence of Orton-Bruce, Sr.’s financial condition before and after the property transfer, there remained genuine issues of material fact to preclude summary judgment on the fraudulent claim.


This case is discussed under the topic heading “Termination and Nonrenewal.”

**DAMAGES**


In this case, the U.S. District Court for the District of Utah addressed a series of motions at the conclusion of a long-running and fractious dispute between Derma Pen, LLC and related parties (Derma Pen parties), on the one hand, and 4EverYoung Limited and related parties (4EverYoung parties), on the other hand. The court granted the Derma Pen parties’ motions, imposed a sweeping permanent injunction, and awarded approximately $11.9 million in damages and almost $3.7 million in attorney fees and costs to the Derma Pen parties.

Derma Pen was a provider of FDA registered micro-needling and skin treatment products and systems (Derma Pen products). Derma Pen had common law rights to the Derma Pen name and had obtained a federal registration for it and other trademarks (Derma Pen marks). Derma Pen was also the owner of copyrights in certain material displayed on its website (Derma Pen copyrighted content). Derma Pen ultimately failed and the Derma Pen marks and the Derma Pen domain name were sold to one of Derma Pen’s creditors.
In 2011, the principals of Derma Pen and 4EverYoung entered into discussions regarding the sale of a micro-needling device and related disposable tips in the United States. During the course of these discussions, defendant Stene Marshall, the then-owner of 4EverYoung, represented that 4EverYoung had the worldwide rights to distribute the micro-needling device and related tips and could grant Derma Pen the right to sell such products in the United States. Marshall also represented that these devices were protected by worldwide patents, although there was only one patent and it was effective only in South Korea. Based on these representations, Derma Pen entered into a distribution agreement with 4EverYoung, pursuant to which Derma Pen had the exclusive right to sell the Derma Pen products and use the Derma Pen marks in the United States and 4EverYoung had the right to use the trademark in the rest of the world. The distribution agreement also provided 4EverYoung with a right of first refusal to purchase Derma Pen’s trademark rights in the event the agreement was terminated.

Derma Pen ultimately terminated the agreement and filed suit against the 4EverYoung parties asserting numerous claims, including claims arising under the Lanham Act, the Copyright Act, and common law. 4EverYoung and one of the other 4EverYoung parties filed counterclaims against the Derma Pen parties seeking specific performance of the contractual right to acquire the Derma Pen marks. Prior to the motions that were the subject of this decision, Derma Pen filed a motion for preliminary injunction, which was denied and then appealed to the Tenth Circuit, and 4EverYoung filed a motion for preliminary injunction and several motions for partial summary judgment, which were granted in at least part.

The motions before the court were the Derma Pen parties’ motions (1) to strike the 4EverYoung parties’ answer, for entry of default, and for a default judgment; (2) for entry of findings of fact and conclusions of law; (3) for terminating sanctions; (4) for an award of damages; and (5) for attorney fees and costs. The court conducted an evidentiary hearing and issued its finding of fact and conclusions of law.

The court found that 4EverYoung and other 4EverYoung parties wrongfully used the Derma Pen marks and domain name in the United States in connection with the sale of micro-needling devices and accessories for at least eighteen months. The court also found that such use was willful and that the defendants intended to improperly benefit from Derma Pen’s reputation and goodwill in the Derma Pen marks because the 4EverYoung parties had: (1) falsely asserted that such use was authorized by the distribution agreement; (2) hired former employees of Derma Pen; (3) stolen Derma Pen’s confidential customer list and pricing information; (4) used Derma Pen-branded signage and marketing materials at trade shows; and (5) expressed their intent to “white ant” Derma Pen, which is Australian slang for destroying a company from within. The court additionally concluded that the defendants had engaged in false advertising related to their unauthorized use of the Derma Pen marks by stating or implying that their micro-
needling products had been approved by the FDA and in other respects. The court further held that the 4EverYoung parties knowingly, willfully, or recklessly used unauthorized reproductions of the Derma Pen copyrighted content or substantially similar content on at least one website.

The court also found that the 4EverYoung parties had willfully or maliciously published false statements about Derma Pen, including that Derma Pen did not have the right to distribute micro-needling products bearing the Derma Pen marks, the Derma Pen products were inferior or unsafe, Derma Pen’s principals were not knowledgeable about micro-needling devices and procedures, and Derma Pen would run out of its products and be unable to service its customers.

The court additionally made a series of findings with respect to Marshall’s conduct in Australia, which had resulted in the Australia Securities and Investments Commission (ASIC) prohibiting him from managing corporations in Australia. The findings, which were based on a report issued by ASIC, included that Marshall had “extensive involvement” with eight companies that failed and owed significant amounts to creditors, that these companies owed back taxes in excess of $600,000, and that Marshall had engaged in “phoenix” activity by transferring the ongoing business of a failing company to a new company and leaving the failed company with no assets to pay creditors.

The court also addressed the 4EverYoung parties’ counterclaims for specific performance of 4EverYoung’s purported right to acquire the Derma Pen marks, finding that defendants had failed to prosecute their claims. The court recounted at length the defendants’ attorney-client relationships with at least seven separate law firms and their repeated failure to comply with the court’s orders that they retain counsel.

Finally, the court issued findings with respect to Derma Pen parties’ asserted damages. In particular, the court found that Derma Pen had a recurring revenue business model and low customer attrition rate, but that Derma Pen’s customer attrition rate increased, sales dropped, and margins compressed after the defendants commenced their wrongful activities. The court found that such changes were “directly attributable” to the defendants’ actions. The court also found that the erosion of Derma Pen’s sales, customer base, and margins, coupled with the fees and costs of the litigation, ultimately resulted in Derma Pen’s failure.

The court then turned to its conclusions of law. The court struck the defendants’ answers to Derma Pen’s operative complaint and then deemed the allegations in the complaint admitted and dismissed the 4EverYoung parties’ counterclaims. The court also held that the 4EverYoung parties were alter egos of each other.

The court awarded Derma Pen lost profits of approximately $7.3 million based on the 4EverYoung parties’ deceptive trade practices, fraudulent representations, disruption of Derma Pen’s ongoing and prospective business
relationships, defamation, and disparagement. The court chose to award statutory damages on the trademark infringement (counterfeit) claims because the amount of actual damages was uncertain. The court noted that statutory damages serve to both compensate the aggrieved party and punish the infringing party and that, in determining the amount to award, courts typically consider the willfulness of the infringement, the defendants’ efforts to mislead and conceal the infringement, the infringing party’s “defiance of attempts at deterrence,” the scale of the counterfeiting operations, and the amount that would prevent future infringement. Without explanation, the court awarded a total of $4 million in statutory damages—$2 million each for the counterfeiting of the micro-needling devices and the counterfeiting of the related tips. Again without explanation, the court also awarded $600,000 in statutory damages for the defendants’ knowing and willful use of the Derma Pen copyrighted content.

The court awarded the Derma Pen parties attorney fees and costs of almost $3.7 million. The award was based on a combination of the attorney fees clause in the distribution agreement, the 4EverYoung parties having “acted in bad faith, vexatiously, wantonly, and for oppressive reasons,” the statutory provisions of the Lanham and Copyright Acts, and the court’s inherent power.

Finally, the court also issued a broad permanent injunction, which: (1) enjoined the 4EverYoung parties from using the Derma Pen marks and trade name in connection with the sale, advertising, and promotion of any good or service; (2) enjoined the defendants from stating or implying they are affiliated or otherwise associated with Derma Pen or any subsequent owner of the Derma Pen marks, ever had any rights in the Derma Pen marks, and making any false or deceptive statements regarding current or former officers, etc. of the Derma Pen parties; (3) enjoined the defendants from committing any defamation, disparagement, or unfair business practices directed toward obtaining Derma Pen’s business, or diminishing the goodwill or reputation of Derma Pen or any subsequent owner of the Derma Pen marks; (4) required the defendants to deliver to Derma Pen or destroy any products or materials bearing the Derma Pen marks or the Derma Pen copyrighted content; (5) required the defendants to deliver to Derma Pen a list and contact information of all parties to whom they had sold or offered to sell products bearing the Derma Pen marks; (6) prohibited the defendants from selling any micro-needling device or tips to any party to whom they had previously sold devices bearing the Derma Pen marks; and (7) required the defendants to deliver to Derma Pen or destroy all materials bearing any false or impliedly false statement regarding the defendants’ micro-needling devices, or Derma Pen and its current/former investors, officers, etc. The court also required the defendants to file a report under oath within thirty days of the order setting forth in detail the manner in which they had complied with the injunction.
FRAUD

This case is discussed under the topic heading “Contract Issues.”

INJUNCTIVE RELIEF

This case is discussed under the topic heading “Damages.”

This case is discussed under the topic heading “Arbitration.”

In a dispute between two companies over a sales representative’s non-compete agreement, the Third Circuit remanded the matter to the district court to properly analyze all of the four factors required to grant injunctive relief to the former employer.

Fres-co Systems USA, Inc. hired Kevin Hawkins as a sales representative to sell Fres-co flexible packing services, including coffee packaging, for different businesses and products. As a condition of employment with Fres-co, Hawkins signed Fres-co’s confidentiality and non-competition agreement, which stated that Hawkins could not compete with Fres-co in any line of business; accept employment with or be employed by a competitor of Fres-co in any line of business; or solicit business from, contract with, be employed by, or otherwise do business with any Fres-co customer during the term of his employment with Fres-co and for one year after the termination of his employment. The non-compete agreement defined a “line of business” as any business involved in the manufacture, development, or sale of flexible packing services, including those companies involved in the sale of coffee, pet food, and agricultural chemicals.

During his tenure with Fres-co, Hawkins serviced the company’s West Coast coffee packaging customers and served as Fres-co’s primary sales representative for those customers in Washington, California, Hawaii, and Texas. His twelve largest accounts generated over $1 million in annual revenue for Fres-co.
Sixteen years later, Hawkins informed Fres-co that he was leaving the company and had accepted a job with a Fres-co competitor, Transcontinental Ultra Flex, Inc. Hawkins told his sales director that he would likely be servicing Transcontinental’s coffee packaging customers. When the sales director reminded Hawkins that he had signed a non-compete agreement, Hawkins declined to confirm he would not solicit Fres-co customers with whom he had worked. Hawkins also did not commit to honoring his other obligations under the non-compete agreement.

Fres-co sued Hawkins for breach of contract, misappropriation of trade secrets under state law and the federal Defend Trade Secrets Act, and interference with existing and prospective contractual relationships. Fres-co subsequently amended its complaint to name Transcontinental as a defendant and to seek injunctive relief and damages. Fres-co later moved for a temporary restraining order and/or preliminary injunction to: (1) require Hawkins to return any Fres-co records in his control or possession; (2) enjoin Hawkins from using or disclosing Fres-co’s proprietary business information and/or trade secrets; and (3) prevent Hawkins from communicating with any of the top twelve coffee packaging account customers that Hawkins had serviced at Fres-co. As part of its request for the temporary restraining order, Fres-co attached an affidavit from the sales director. Hawkins and Transcontinental opposed Fres-co’s motion and included an affidavit from Hawkins in which he denied being aware of any Fres-co trade secrets. Hawkins also represented in his affidavit that he would not disclose or otherwise use any confidential information he learned while at Fres-co.

The district court granted the preliminary injunction after holding oral arguments on the matter, but not taking any additional evidence. Pursuant to the court’s order, Hawkins was not prevented from working at Transcontinental; however, he was required to return any Fres-co materials in his possession; prevented from using or disclosing his former employer’s proprietary information and trade secrets; and prohibited from soliciting, contacting, or communicating with the top twelve Fres-co coffee packaging accounts. Hawkins and Transcontinental appealed to the Third Circuit.

Under federal law, a court may issue a preliminary injunction if: (1) the plaintiff shows that it is likely to succeed on the merits; (2) the plaintiff shows that it is likely to suffer irreparable harm without the injunction; (3) the balance of equities do not disfavor granting the injunction; and (4) public interest concerns do not outweigh the interests advanced by the issuing the injunction. The Third Circuit rejected the defendants’ challenge of the district court’s finding of irreparable harm. It found that the district court did not abuse its discretion in finding irreparable harm because there was evidence of substantial overlap between Hawkins’ work for Fres-co and the work he intended to do for Transcontinental given that it was the “same role, same industry, and same geographic region.” Accordingly, the Third Circuit found that the district court was within its discretion to
conclude that Hawkins would likely use the confidential knowledge he gained at Fres-co in his new role at Transcontinental.

The Third Circuit determined, however, that remand was appropriate because the district court did not mention Fres-co’s causes of action or analyze the elements of any of them to determine whether Fres-co was likely to succeed on the merits of its claims. It observed that a finding that Fres-co was likely to succeed on the merits required, among other things, an analysis of the information to which Hawkins had access to determine whether they were trade secrets under statutory law and an analysis of whether the non-compete agreement was reasonably necessary for Fres-co’s protection and also reasonably limited in duration and geographic scope. The Third Circuit noted that even if the district court had engaged in this analysis to find that Fres-co was likely to succeed on the merits, remand would still be appropriate because the district court had failed to address the final two preliminary injunction factors. Because the district court did not analyze the last two factors, it could not determine whether the district court reasonably exercised its discretion in granting injunctive relief.


Plaintiff Stockade Companies, LLC owns and licenses the trademarks for Sirloin Stockade, Coyote Canyon, and Montana Mike’s restaurants. Stockade entered into fifteen franchise agreements with defendant Kelly Restaurant Group (KRG). KRG failed to make the required royalty payments and Stockade sent a notice of default in January 2017. KRG failed to cure the default and Stockade sent a notice of termination, advising KRG to immediately cease using Stockade’s proprietary marks. Nevertheless, KRG continued to operate multiple restaurants using the Sirloin Stockade, Coyote Canyon, and Montana Mike’s trademarks. As a result, Stockade filed a lawsuit against KRG in the U.S. District Court for the Western District of Texas, as well as a motion to enjoin KRG from infringing on Stockade’s marks, violating the non-compete provisions in the franchise agreements, and using or transferring Stockade’s confidential information. The motion was granted in part and denied in part.

The court initially noted that a preliminary injunction is an extraordinary remedy and granting such relief should be the exception rather than the rule. In order to obtain a preliminary injunction, the moving party must establish that it is likely to succeed on the merits, it is likely to suffer irreparable harm in the absence of injunctive relief, the balance of equities tips in its favor, and an injunction is in the public interest.

The court granted an injunction prohibiting KRG from infringing on Stockade’s marks. The court held it was clear that KRG was using the marks without Stockade’s permission and, when a likelihood of confusion exists, the plaintiff’s lack of control over the quality of the defendant’s goods or
services constitutes an immediate irreparable injury. Although KRG argued that it would suffer significant harm because it would have to close its restaurants, breach its lease agreements and contracts with third-party vendors, attempt to pay rent without any income, and lay off more than 500 employees, the court found that these alleged harms would not result from de-branding, but would instead result from enforcement of the non-compete, which was a separate issue. Finally, the court found that it would be in the public interest to enjoin KRG from using Stockade’s marks because trademark law exists to protect the consuming public from confusion.

The non-compete at issue provided: “Franchisee shall not have any interest . . . in . . . any concept which is similar to any franchise concept owned, operated, licensed, or franchised by Franchisor (similar concepts) . . . within a radius of 50 miles from any franchisor-owned or affiliate-owned restaurant or any franchise concept owned, operated, licensed, or franchised by Franchisor, wherever situated and operated by whomever, then open or under construction or under lease for purchase commitment . . . for a period of three years following the expiration or termination of the agreement.” Stockade argued that because KRG continued to operate the franchised restaurants, it was likely to succeed on its claims that KRG was violating the post-termination non-compete provisions. At the hearing, Stockade suggested that KRG might not be able to operate any restaurant in the cities in which its former franchised locations were located. The court held, however, that after KRG de-branded the restaurants, the restaurants would not fall within a 50-mile radius of any other Stockade-owned or affiliate-owned restaurant currently in operation and, therefore, permitted KRG to operate restaurants at the former franchised locations as long as they did not use Stockade’s marks.

Stockade also sought to enjoin KRG from using its confidential information, arguing that because KRG was continuing to operate its restaurants under Stockade’s marks, it was impermissibly using Stockade’s confidential information. The court concluded, however, that because KRG would be enjoined from operating any Stockade-branded restaurant, there was no evidence suggesting KRG would use Stockade’s confidential information. Therefore, the court implied that access to confidential information does not presume unlawful use subsequent to termination of a franchise.

JURISDICTION

The U.S. District Court for the Northern District of California granted defendant AAAC Support Services, LLC’s motion to dismiss plaintiff Pest-
master Franchise Network, Inc.’s claims against AAAC for lack of personal jurisdiction and denied Pestmaster’s request for jurisdictional discovery.

Pestmaster is a franchisor of pest control businesses. Defendants Jinny and Gabe Mata entered into two franchise agreements with Pestmaster pursuant to which they were granted the right to operate Pestmaster franchises in Texas. The franchise agreements included a California forum selection clause and provided Pestmaster with a right first refusal in the event the Matas sought to sell their franchises.

In 2016, the Matas sold their businesses to defendants Josie and Brian Moss although Pestmaster had advised the Matas that it was interested in exercising its right of first refusal and requested a copy of the written purchase offer. The Mosses formed a new entity, Moss Pest Control, LLC, in connection with the formerly franchised Pestmaster businesses. According to Pestmaster, AAAC is owned by the Mosses and is in the business of franchising pest and animal control businesses.

Pestmaster filed a complaint in federal court asserting numerous claims against the defendants, including breach of contract, conspiracy, fraud, unfair competition, and misuse of trade secrets. In response, AAAC filed a Federal Rule of Civil Procedure Rule 12(b)(2) motion to dismiss for lack of personal jurisdiction. Pestmaster argued that AAAC was subject to both specific and general jurisdiction in California because it has three California-based franchisees and consented to jurisdiction in California because it was bound as a non-signatory to the forum selection clause in the franchise agreements between the Matas and Pestmaster.

The court started by addressing the basic jurisdictional ground rules. First, personal jurisdiction over a non-resident is appropriate only if it is consistent with the state’s long-arm statute and fundamental principles of due process. Second, because California long-arm statute is “coextensive” with federal due process, the jurisdictional analyses under both and state and federal law are the same. The court then turned to Pestmaster’s jurisdictional arguments.

The court reiterated that general jurisdiction is appropriate only when a defendant’s contacts with the forum state are so “continuous and systematic” that the defendant would essentially be “at home” in the state. Citing to the Supreme Court’s decision in *Daimler AG v. Bauman*, 134 S. Ct. 746 (2014), the court noted that the “paradigm” for general jurisdiction is a corporation’s place of incorporation and principal place of business and that only in exceptional cases will there be general jurisdiction elsewhere. Pestmaster argued that AAAC was “at home” in California because it had three franchisees in the state and was actively recruiting new franchisees in California. The court disagreed, finding that AAAC’s contacts with California were much less than those that the Supreme Court found to be insufficient in *Daimler* and were “minor” when compared to AAAC’s contacts elsewhere.

The court also found that there was no indication California was especially significant to AAAC or that AAAC targeted California consumers or solic-
ited prospective franchisees in California. In all events, the court found that exercising general jurisdiction would be contrary to the Supreme Court’s guidance in *Daimler* that a “corporation that operates in many places can scarcely be deemed to be at home in all of them.”

The court then considered Pestmaster’s arguments regarding specific jurisdiction. In the Ninth Circuit, there is a three-pronged test for specific personal jurisdiction. First, the defendant must have “purposefully” directed its activities to the forum to such a degree that “it should reasonably anticipate being haled into court there;” second, the claims must arise out of or relate to the defendant’s activities in the forum such that the plaintiff would not have suffered an injury “but for” those activities; and third, exercising jurisdiction must “comport with fair play and substantial justice.” The court found that Pestmaster had failed to prove that it would not have suffered harm “but for” AAAC’s contacts with California because (1) the Asset Agreement between the Matas and Moss Pest Control was executed in Texas and involved the sale and alleged misuse of assets in Texas, (2) Pestmaster’s claimed loss of market share was in Texas, and (3) any harm to Pestmaster’s California offices and franchise system was “only remotely and indirectly” related to AAAC’s conduct that formed the basis for Pestmaster’s claims.

Pestmaster’s argument that AAAC consented to personal jurisdiction because it was bound as a non-signatory to the forum selection clause in the franchise agreements between Pestmaster and the Matas fared no better. The court first discussed two Ninth Circuit decisions in which non-signatories to a contract were bound to a forum selection clause—*Manetti-Farrow, Inc. v. Gucci America, Inc.*, 858 F.2d 50 (9th Cir. 1988), and *Holland America Line Inc. v. Wartsila North America, Inc.*, 485 F.3d 450 (9th Cir. 2007). The court held that in those cases the non-signatories had “consented” to the forum selection clause because they “were intimately involved in the ratification or execution of the contract containing the forum selection clause.” The court contrasted such circumstances with the facts here in which there was no allegation that AAAC was involved in the formation or execution of the franchise agreements and no evidence of a pre-existing relationship between AAAC and either of the parties to the franchise agreements. The court further distinguished *Manetti-Farrow* and *Holland America* on the basis that in those cases, the non-signatory defendants sought to enforce the forum selection clause against a signatory plaintiff. Thus, unlike AAAC’s argument, there was no issue that the defendant was “unfairly” being subjected to jurisdiction without “fair warning” that its activities may result in jurisdiction.

Finally, the court addressed Pestmaster’s request to seek jurisdictional discovery. The court noted that such discovery should generally be permitted, but that it is within a court’s discretion to deny discovery “when it is clear that further discovery would not demonstrate facts sufficient to constitute a basis for jurisdiction.” The court concluded that because there were no jurisdictional facts in dispute, the request for jurisdictional discovery was properly denied.
TeamLogic Inc., a franchisor of IT services, suing a former franchisee, Meredith Group IT, LLC (MIT), its owner Karen Meredith, her son Matt Meredith, and a former employee of the franchisee, John Miller, for alleged misappropriation of trade secrets, conversion, trademark infringement, conspiracy, interference with business relationships, and breach of contract, and sought injunctive relief as well as damages and attorney fees.

MIT is a Texas limited liability company with its principal place of business in Texas. TeamLogic is a California corporation with its principal place of business in California. In July 2006, TeamLogic entered into a ten-year franchise agreement with MIT. Sometime in 2015, MIT decided not to renew the franchise agreement. Karen’s son, Matt Meredith, who handled marketing for MIT, formed Green Bean IT, LLC and registered the domain name www.tlit.com, knowing that “tlit” was an acronym for TeamLogic. TeamLogic claimed that he did so to make it easier to divert MIT’s customers to Green Bean upon expiration of the franchise agreement. TeamLogic also claimed that Karen continued to lead the franchisor to believe that she was considering renewal so that TeamLogic would not take steps to transition her customers to another franchisee in accordance with the franchise agreement and the customers could later be diverted to Green Bean. Karen also did not send notices to MIT’s customers and suppliers about the transition to another franchisee at the expiration of the franchise agreement, which she was required to do. Additionally, John Miller forwarded customer lists to another former employee of MIT and diverted incoming emails to Green Bean.

Miller and Matt designed Green Bean’s website, which had the same color scheme and taxonomy as TeamLogic’s branded materials. TeamLogic alleged that Karen simply looked the other way, knowing that MIT’s employees Matt and Miller set up Green Bean to do business with MIT’s former customers upon expiration of the franchise agreement even though the agreement required that those customers be transitioned to another Texas-based franchisee.

MIT filed a Federal Rule of Civil Procedure 12(b)(1) motion to dismiss TeamLogic’s claims for lack of subject matter jurisdiction. The court held that when determining whether to grant a Rule 12(b)(1) motion, the court must presume that the suit lies outside of its limited jurisdiction and the burden of establishing federal jurisdiction rests on the party seeking the federal forum. The court noted that diversity jurisdiction is proper only when complete diversity exists between the parties and the matter in controversy exceeds $75,000, exclusive of interest and costs. The court also noted that a party asserting diversity jurisdiction must affirmatively allege the citizenship of the parties. Although TeamLogic pled that it was a citizen of California because it was incorporated and had its principal place of business there,
TeamLogic failed to allege the citizenship of the members of MIT. Additionally, to the extent TeamLogic addressed the location of Miller, Matt, and Karen, it did so only by alleging they were residents of Texas but it did not distinctly and affirmatively allege the citizenship of each individual defendant member of the LLC. The court noted that residency is not at issue when determining whether diversity jurisdiction exists because a citizen of one state may reside in another state of which he is not a citizen. Therefore, the court held that by failing to allege the citizenship of the individual defendants and the citizenship of all members of the LLC, TeamLogic had failed to establish that there was diversity jurisdiction.

This, however, did not end the jurisdictional inquiry because TeamLogic also alleged the existence of federal question jurisdiction. The court noted that federal question jurisdiction exists in all civil actions arising under the Constitution, laws, or treaties of the United States. 28 U.S.C. § 1331. A federal question is presented when a well-pleaded complaint establishes that federal law creates the cause of action or that the plaintiff’s rights to relief depend on a resolution of a substantial question of federal law. To determine whether there is a substantial question of federal law, courts must determine whether: (1) resolving a federal issue is necessary to resolution of the state law claim, (2) the federal issue is actually disputed, (3) the federal issue is substantial, and (4) federal jurisdiction will not disturb the balance of federal and state responsibilities. The court held that because TeamLogic’s complaint clearly alleged claims against Matt and Green Bean for trademark infringement under the Lanham Act as the basis for jurisdiction, the court had subject-matter jurisdiction over the trademark infringement claims.

The question then became whether the court had supplemental jurisdiction over the remaining state law claims under 28 U.S.C. § 1367(a). The court noted that courts have supplemental jurisdiction over claims that are so related to claims in the action within its original jurisdiction that they form part of the same case or controversy. Thus, a federal court may hear state law claims if the federal issues are substantial and the state and federal claims derive from a common nucleus of operative facts. The court found that TeamLogic’s state and federal claims (1) related to the same franchise agreement and interactions and (2) formed part of the same case or controversy. Therefore, the court held that it would exercise supplemental jurisdiction over the state claims.

MIT also moved to dismiss TeamLogic’s claims under Federal Rule of Civil Procedure 12(b)(6) for failure to state a claim upon which relief can be granted. In order to survive a Rule 12(b)(6) motion to dismiss, the pleadings must include well-pleaded facts, not mere conclusory allegations. The court must accept well-pleaded facts as true and view them in the light most favorable to the plaintiff, and such a complaint will survive a motion to dismiss even if the judge believes that the actual proof of facts is improbable and that recovery is remote or unlikely.
With respect to the misappropriation of trade secrets claim, MIT argued that TeamLogic failed to allege any property that actually qualified as a trade secret and that TeamLogic failed to identify any confidential or proprietary information that MIT disclosed or used without consent. Under Texas law, a claim for trade secret misappropriation requires a showing that: (1) a trade secret existed, (2) the trade secret was acquired through breach of a confidential relationship or was obtained by improper means, (3) the defendant used the trade secret without the plaintiff’s authorization, and (4) the plaintiff suffered damages as a result. The court noted that the existence of a trade secret is usually a question of fact to be decided by the fact-finder, based on six relevant criteria: (1) the extent to which the information is known outside the business, (2) the extent to which it is known by employees and others involved in the business, (3) the extent of measures taken to safeguard the secrecy of the information, (4) the value of the information to its owner and competitors, (5) the amount of effort or money expended in developing the information, and (6) the ease or difficulty with which the information could be properly acquired or duplicated by others. The court held that because so many factors go into determining whether a trade secret exists, and because the factors turn on factual considerations gleaned from discovery, the court denied MIT’s motion to dismiss the trade secret misappropriation claims. However, the court noted that customer lists and client information that MIT allegedly used have been recognized as trade secrets.

MIT also moved to dismiss TeamLogic’s conspiracy claims against Karen, arguing that TeamLogic failed to allege there had been a meeting of the minds between Karen and the other MIT defendants to intentionally misappropriate TeamLogic’s information. Under Texas law, a civil conspiracy is a combination by two or more persons to accomplish an unlawful purpose or to accomplish a lawful purpose by unlawful means. The elements are: (1) two or more persons; (2) an object to be accomplished; (3) a meeting of the minds on the object or course of action; (4) one or more unlawful, overt acts; and (5) damages as the proximate result. TeamLogic alleged that Karen, Miller, Matt, and another former MIT employee conspired to misappropriate TeamLogic’s property in order to divert it to Green Bean. Specifically, it alleged that Karen agreed to look the other way while MIT’s employees provided proprietary information and trade secrets to Green Bean and that she delayed sending a mandatory notice to MIT’s customers of her decision not to renew in order to provide time for MIT’s employees to transfer information to Green Bean. Based on these allegations, the court held that TeamLogic had sufficiently alleged facts that could entitle it to relief on a conspiracy claim.

MIT additionally sought to dismiss TeamLogic’s claim against Karen for tortious interference with a business relationship. To establish tortious interference with a business relationship, a plaintiff must plead: (1) a reasonable probability that the parties would have entered into a contract or relationship; (2) an intentional and malicious act by which the defendant prevented
the relationship from occurring, with the purpose of harming the plaintiff; (3) lack of privilege or justification of the defendant to do the act; and (4) actual harm or damage resulting from the defendant’s interference. TeamLogic alleged that it developed business relationships through its franchisees and that by unlawfully diverting customers to Green Bean, MIT prevented future relationships between TeamLogic and its franchisees. TeamLogic alleged that MIT did so in order to benefit itself at the expense of TeamLogic. The court agreed that the allegations sufficiently stated a claim for tortious interference with a business relationship.

The court also rejected MIT’s motion to dismiss TeamLogic’s breach of contract claim. The court held that TeamLogic’s allegations that it had complied with the contract, MIT failed to comply with its obligations and that TeamLogic suffered damages as a result was sufficient to state a claim for breach of contract.

MIT also moved to dismiss TeamLogic’s claims under Federal Rule of Civil Procedure 12(b)(7), arguing that King, one of MIT’s former employees, was an indispensable and necessary party to the litigation because his actions as an employee of MIT and his subsequent employment with Green Bean, as well as his interaction with MIT’s former customers, were at the very heart of TeamLogic’s claims. Rule 12(b)(7) allows for dismissal of a case for failure to join a party under Federal Rule of Civil Procedure 19, which provides for the joinder of all parties whose presence in a lawsuit is required for the fair and complete resolution of the dispute at issue. The court found that although King may have been relevant to the dispute, he was essentially a joint tortfeasor and joint tortfeasors are not necessary parties under Rule 19. Additionally, the court noted that because TeamLogic could obtain complete relief without joinder of this former employee, he was not an indispensable party under Rule 19.

Finally, MIT asked the court to abstain from exercising jurisdiction and dismiss the case under the Colorado River Doctrine, which requires a court to give regard to conservation of judicial resources by abstaining from a case where a similar action is pending in state court. In order for the Colorado River Doctrine to apply, a court must be satisfied that there is a parallel proceeding pending in state court and that exceptional circumstances warrant abstention. The court held that the burden was on MIT to prove that adequate justification exists for abstention and that the court should abstain only when the clearest of justifications warrant it. King, one of MIT’s former employees, who was not currently a party to the case, filed a declaratory judgment action against TeamLogic in state court before TeamLogic filed this lawsuit. None of the MIT defendants in the federal case, however, were parties in the state case. The court held that the absence of the same parties and the same issues resulted in a failure to show that the federal and state cases were parallel proceedings as required by the Colorado River Doctrine to justify abstention.
Plaintiff Traffic and Parking Control Company, Inc. (TAPCO) filed an action against defendant Global Traffic Technologies, LLC (GTT) in Milwaukee County Circuit Court. The complaint arose from GTT’s attempt to terminate the parties’ dealership agreement, which TAPCO alleged was a breach of the agreement and the Wisconsin Fair Dealership Law (WFDL). GTT removed the action to the U.S. District Court for the Eastern District of Wisconsin on the basis of diversity jurisdiction under 28 U.S.C. § 1332(a)(1). This case addressed TAPCO’s motion to remand the case to state court on the ground that the amount in controversy was less than $75,000 and GTT’s motion to dismiss TAPCO’s complaint on the ground that TAPCO’s complaint failed to state a claim for violations of the WFDL or for breach of contract.

TAPCO alleged that GTT sent it an email on November 3, 2016, stating that the parties’ agreement would be canceled effective February 1, 2017. TAPCO claimed the email provided no reason for the proposed cancellation and, therefore, GTT did not have “good cause” to cancel the agreement as required under the WFDL. Additionally, although the agreement gave either party the right to terminate without cause on ninety days’ written notice, TAPCO asserted that this provision was unenforceable because it violated the WFDL. TAPCO also asserted a breach of contract on the ground the termination without cause violated GTT’s common law duty of good faith and fair dealing. TAPCO further claimed that the November 3 email did not constitute appropriate written notice because the agreement required that any notices be served by personal delivery, registered mail, prepaid post with receipt requested, or facsimile. TAPCO sought declaratory relief that the termination was void and to enjoin the cancellation of the dealership agreement. TAPCO did not seek damages or attorney fees in the lawsuit.

The court first dealt with the jurisdictional question of whether the amount in controversy exceeded $75,000 as required for diversity jurisdiction under 28 U.S.C. § 1332. The court noted that in the Seventh Circuit the inquiry is not confined to an analysis of the claimed damages, but includes more generally “the amount at stake to either party to the suit.” As the party seeking federal court jurisdiction, GTT had the burden of showing by a preponderance of the evidence that the amount in controversy requirement had been met. The court noted that although GTT had the burden of proof, it only had to provide a good faith estimate that the amount at stake exceeded the $75,000 threshold. After setting forth a good faith estimate that the $75,000 threshold had been met, a plaintiff can defeat diversity jurisdiction only if it appears to a legal certainty that the amount at stake is really less than $75,000.

GTT submitted an affidavit stating that an injunction prohibiting the termination of the agreement would be worth more than $75,000 because
GTT’s sales for 2013 through 2016 were over $500,000 per year and that TAPCO’s estimated gross profit margin was 20 percent of GTT’s annual sales to TAPCO. Therefore, GTT estimated that TAPCO would make well over $75,000 if the dealership arrangement continued. TAPCO argued that GTT had no way of knowing what TAPCO’s profit margins were and, therefore, could not place a reliable dollar figure on the value of the dealership agreement to TAPCO. TAPCO also argued that the amount in controversy was less than $75,000 because the dispute concerned only a ninety-day period since GTT could reissue a second notice complying with the WFDL and the dealership agreement. TAPCO argued that the amount in controversy for this ninety-day period was only $31,000. The court found that GTT’s good faith estimate of the amount in controversy was sufficient. First, TAPCO’s argument that there was only a ninety-day period at issue in this case was incorrect because it did not account for TAPCO’s request that termination be enjoined in the future. Moreover, because TAPCO claimed that there was no good cause for termination, GTT could not simply reissue a notice of termination to be effective within ninety days. Additionally, TAPCO failed to produce any actual evidence that the value of its claims was less than $75,000, which it could have done given its control of its financial records. Thus, the court held that the amount in controversy element was satisfied and the motion to remand was denied.

GTT also moved to dismiss the complaint on the ground that it failed to state a claim for relief. To state a viable claim, a complaint must (1) provide a short and plain statement of the claim establishing that the pleader is entitled to relief and (2) give fair notice of the nature of the claim and the grounds upon which it rests. The allegations must plausibly suggest that the plaintiff has a right to relief, raising the possibility above mere speculation. GTT argued that it properly terminated the agreement, claiming that the November 3, 2016, email was proper notice because, although the agreement required all notices to be made in certain specified forms, the contact information each party provided in that section included their respective email addresses. Therefore, GTT argued that the email complied with the contractual requirements. GTT also asserted that TAPCO claimed no damages from the alleged breach and that TAPCO’s theory based on the duty of good faith and fair dealing should be rejected as conclusory.

The court held that TAPCO’s claims passed muster at this stage of the proceeding because, on its face, the dealership agreement required notice to be given only in certain specified forms and an email was not sufficient under the notice provision. Although GTT had reasonable arguments that an email did not violate the contract or that GTT substantially complied with the notice requirements, the court held that it was inappropriate to decide whose reading of the agreement was the better one without the benefit of discovery. The court also rejected GTT’s argument that TAPCO’s lack of damages should result in dismissal because damages are not the only form of harm, and TAPCO was clearly seeking to prevent other forms of harm, in-
cluding a loss of its investment of time and money in the dealership and that the loss of its dealership arrangement would make TAPCO less competitive in its market.

The court, without explanation, summarily denied the motion to dismiss the other claimed breaches of contract and TAPCO’s claims under the WFDL.

LABOR AND EMPLOYMENT


The U.S. District for the Northern District of California granted a cleaning franchisor’s motion for summary judgment in a wage-and-hour putative class action matter where the plaintiffs alleged they were wrongly classified as independent contractors instead of employees in a three-tiered franchise structure.

Jan-Pro Franchising International, Inc., the franchisor of cleaning and janitorial services businesses, operates a three-tiered franchising structure. As part of that structure, Jan-Pro sells franchise rights to regional master franchisees who obtain the exclusive right to sell unit franchise rights and serve as master franchisees for the Jan-Pro business in their defined geographic territories. The unit franchisees in a regional master franchisee’s territory have the right to service certain accounts that the regional master franchisee provides to them. The regional master franchisee provides its unit franchisees with initial training, business development, billing and collection, and revenue disbursement services.

The three plaintiffs, residents of California, were unit franchisees of two Jan-Pro regional master franchisees that were not joined as parties to the case. The plaintiffs had originally sued Jan-Pro in an amended complaint previously filed in the U.S. District Court for the District of Massachusetts. During the summary judgment phase of the Massachusetts case, the court focused on the claims of the Massachusetts plaintiff as a test case. After granting summary judgment to Jan-Pro on most of its claims, the Massachusetts plaintiff dismissed the remaining two claims. The three California plaintiffs successfully moved to sever and transfer the matter to the Northern District of California. The California plaintiffs argued they were employees of Jan-Pro under California law, notwithstanding their contractual relationship with the two regional master franchisees and, as such, were entitled to be paid minimum wage and overtime premiums.

Although both sides agreed that California law applied to the plaintiffs’ classification claims, they disagreed over which common law standard applied to the instant case. Jan-Pro claimed that the standard in Patterson v. Domino’s Pizza, LLC, 333 P.3d 723 (Cal. 2014) applied. In Patterson, a case
involving a franchisee employee’s claims for vicarious liability against Domino’s for sexual harassment by a supervisor, the court held that a franchisor could be potentially liable for actions of the franchisee’s employees if the franchisor retained or assumed a general right of control over certain facets of the day-to-day operations of the franchised business, such as hiring, supervision, and discipline of the franchisee’s employees. The plaintiffs, on the other hand, contended that the standard in *Martinez v. Combs*, 231 P.3d 259 (Cal. 2010), applied. In *Martinez*, the court established three alternative definitions of the phrase “to employ” under California labor law: (1) to exercise control over the wages, hours, or working conditions; (2) to suffer or permit to work; or (3) to engage, consequently creating a common law employment relationship. The plaintiffs claimed that Jan-Pro was their employer under any of the three definitions set forth in *Martinez*.

Finding that no binding decision had addressed the standard applicable to the determination of whether a franchisor is an employer of a franchisee, the court applied the *Martinez* standard “with the gloss” of the *Patterson* standard to the plaintiffs’ claims. Using this hybrid approach, the court rejected the plaintiffs’ arguments that Jan-Pro exercised control over or had the right to control their wages, hours, or working conditions. The plaintiffs argued that Jan-Pro’s master franchise agreements with the regional master franchisees gave Jan-Pro the right to control the business of any regional master franchisee as well as the unit franchisees because Jan-Pro had the right to establish policies and procedures for their businesses. Notably, although the master franchise agreements required the regional master franchisees to include a provision in their unit franchise agreements that Jan-Pro was a third-party beneficiary to the unit franchise agreements, none of the unit franchise agreements at issue contained this language. The court also observed that although the plaintiffs were subject to several measures of control by their regional master franchisees, those provisions conferred no rights upon Jan-Pro and the plaintiffs never entered into any other agreements directly with Jan-Pro. Aside from Jan-Pro’s right to modify policies that applied to the regional master franchisees, the court found that the plaintiffs failed to offer any evidence that Jan-Pro satisfied the first factor of either the *Martinez* standard or the *Patterson* standard.

The court also found there was no evidence that Jan-Pro had the authority to stop the unit franchisees from working. Although the master franchise agreements purported to give Jan-Pro that authority, the actual unit franchise agreements did not extend that authority to Jan-Pro. The court also rejected an ostensible agency theory advanced by the plaintiffs alleging that Jan-Pro became their employer because the regional franchisees were the ostensible agents of Jan-Pro. The court determined that these allegations were unfounded because the plaintiffs had no knowledge of Jan-Pro the franchisor until the lawsuit and there was no other evidence that the regional master franchisees acted as agents of any other principal.
NON-COMPETE AGREEMENTS


Colorado Security Consultants, Inc. and others (CSC) filed suit against Signal 88 Franchise Group, Inc. and related LLCs (Signal 88) in the U.S. District Court for the District of Nebraska asserting claims based on Signal 88’s alleged breach of the parties’ franchise agreement. In response, Signal 88 filed a counterclaim and motion to enforce the covenant not to compete in the franchise agreement. After considering each of the traditional four factors applicable to requests for injunctive relief, the court denied Signal 88’s motion.

Signal 88 is in the business of franchising a “unique management and business system for security services.” In 2010, CSC executed a franchise agreement to own and operate a Signal 88 franchise for a three-year term in Colorado Springs, Colorado. The franchise agreement was not formally renewed in 2013, but the parties agreed to extend the term of the agreement and entered into an amendment in 2015 to continue the agreement on a month-to-month basis. The amendment provided that it could be terminated on thirty days’ notice, although CSC claimed that Signal 88 had promised to “formally renew” the franchise agreement in 2016.

The franchise agreement included a broad covenant not to compete, barring the franchisee from selling the services sold by Signal 88 within seventy-five miles of the franchisee’s exclusive territory for a three-year period after the termination of the parties’ relationship. The covenant not to compete expressly permits a court to revise its scope to make it enforceable. The franchise agreement also included a right of first refusal pursuant to which CSC had the right to purchase any proposed new franchise within thirty miles of its territory on the same terms being offered to the prospective franchisee.

In early 2016, Signal 88 advised CSC that a prospective franchisee was interested in acquiring a Signal 88 franchise in Colorado Springs. Signal 88, CSC, and the prospective franchisee discussed a variety of potential business arrangements, including CSC selling its territory to the prospective franchisee, reconfiguring CSC’s territory, and compensating CSC for potential lost business. After the prospective franchisee acquired a Signal 88 franchise, the parties apparently continued to discuss a potential buy-out or modification of CSC’s territory. The discussions ended without an agreement being reached, and Signal 88 demanded that CSC stop servicing customers in the new franchisee’s territory, which was within the area to which CSC had a right of first refusal.

In September 2016, Signal 88 advised CSC that Signal 88 would terminate the franchise agreement effective October 31. Since then, CSC has been providing security services under the name “Guardhail,” and allegedly contacted Signal 88’s customers, undercut Signal 88’s prices, and “caused a
number of customers to cancel contracts with Signal 88.” As a result, Signal 88 sought to enjoin CSC from competing within seventy-five miles of its former Signal 88 territory.

The court started its analysis by noting it did not doubt that Signal 88 faced a threat of harm, but that the relevant inquiry is whether such harm is irreparable or whether it could be remedied “after the fact with a permanent injunction and damages.” The court found that Signal 88’s evidence was “not particularly compelling.” Specifically, the court found that although Signal 88 had identified the purposes of the covenant not to compete—including to maintain customer goodwill and prevent former franchisees from using confidential information to compete with Signal 88—Signal 88 had failed to establish that CSC’s actions were actually threatening that goodwill and it was unclear how such harm could occur because CSC was not using Signal 88’s trademarks.

The court identified several factors that may support a finding of irreparable harm, including price erosion, loss of goodwill, damage to reputation, and also noted that in some circumstances money damages may not be sufficient to remedy economic harm if such harm “is impossible to measure adequately.” But the court also observed that some cases have found that a loss of customers or customer goodwill is not irreparable in that such harm may be addressed through money damages.

The court was unpersuaded by Signal 88’s argument that CSC’s solicitation of Signal 88’s customers established irreparable harm because there was no evidence that Signal 88’s “very existence” was threatened or that its goodwill was “being substantially threatened.” The court was also unpersuaded by Signal 88’s contention that CSC’s actions were causing irreparable harm to its contractual relationships and franchise system, finding there was nothing to distinguish the circumstances from any other case in which “the integrity of a contract is at issue.”

Having found that Signal 88 had not established that it was likely to sustain irreparable harm absent an injunction, the court unsurprisingly found the balance of harms weighed in CSC’s favor. The court concluded that the requested injunction would be “devastating” to CSC and “effectively close” its business, which would moot “several of the parties’ claims before they have been addressed on the merits.”

Prior to addressing the merits of Signal 88’s claims, the court first analyzed whether to apply Nebraska law as urged by Signal 88 or Colorado law as advocated by CSC. Although the franchise agreement included a Nebraska choice-of-law provision, the court essentially found that Colorado had a greater material interest in the agreement because the franchised business was located there. The court further found that there was a fundamental difference in the laws of Nebraska and Colorado. Under Nebraska law, a court will not reform an unreasonable covenant not to compete to make it enforceable, whereas Colorado law permits such reformation. Accordingly, the court held that Colorado law applied.
The court then turned to whether the covenant not to compete was enforceable, noting that non-compete provisions are generally disfavored under Colorado law and are enforced only in limited circumstances, including to the extent necessary to protect trade secrets. The court concluded, however, that although the facts “suggest[ed]” a possibility of success on the merits, Signal 88 had failed to provide sufficient evidence from which the court could determine whether the covenant not to compete was reasonable in scope, geographical reach and duration, and, therefore, enforceable.

Finally, the court held that the public interest did not weigh in favor of granting or denying the requested injunction because whether Signal 88 was likely to prevail on the merits of its claims was unclear, and the general public interest in enforcing contractual obligations was offset to at least some extent by the “strong public interest in encouraging, rather than stifling, competition.”

This case is discussed under the topic heading “Termination and Non-renewal.”

This case is discussed under the topic heading “Injunctive Relief.”

This case is discussed under the topic heading “Injunctive Relief.”

**STATUTORY CLAIMS**

The U.S. District Court for the Western District of Washington addressed whether the Washington Wholesale Distributors and Suppliers of Spirits or Malt Beverages Act (Act) provides a single remedy when a supplier terminates a distributor’s contract without cause, i.e., “compensation from the successor distributor for the laid-in cost of inventory and for the fair-market value of the terminated distribution rights.” Pabst Brewing Company terminated its distribution agreement with Marine View Beverage, Inc. and arranged for another distributor to take over Marine View’s former territory. At the time of the termination, the successor distributor had yet to reach an
agreement with Marine View on the fair market value for the lost distribution rights. Marine View sued Pabst to recover its lost profits, business interruption damages, lost investment, reliance damages, and other losses.

Pabst moved to dismiss Marine View’s complaint, arguing that the Act limited Marine View’s remedies to recovering the fair market value of the distribution rights. Marine View, on the other hand, argued the Act does not authorize termination without cause and does not limit the remedies available to a terminated distributor to compensation for the fair market value of the distribution rights. Marine View asked the court to grant it partial summary judgment and declare that Pabst’s interpretation of the Act was incorrect because the Act does not prohibit Marine View from seeking relief under common law. Marine View also asked the court to determine whether the Act authorizes a supplier to terminate a distributor without cause.

Pabst argued that it could terminate the agreement without cause because the Act provides that “[i]f an agreement of distributorship is terminated, canceled, or not renewed for any reason other than for cause . . . the wholesale distributor is entitled to compensation from the successor distributor for the laid-in cost of inventory and for the fair market value of the terminated distribution rights.” WASH. REV. CODE § 19.126.040(4). The court disagreed with Pabst, holding that the legislature’s acknowledgment of termination without cause was not synonymous with its authorization of termination without cause: “Had the legislature intended to permit suppliers to cancel a distributor’s rights without cause, it would not have mandated that in most circumstances a distributor must have an opportunity to cure the cause leading to its potential termination.”

Pabst argued further that the Act governs the entire relationship between the distributor and its supplier and, therefore, the distributor’s sole remedy was for the successor distributor to make the terminated distributor whole by purchasing its existing inventory and paying the fair market value for the lost distribution rights. Marine View argued that the Act does not provide the exclusive remedy, but merely creates an additional remedy for terminations without cause. The court noted that the statute expressly authorizes payment to a terminated distributor from parties other than a successor distributor. The Act provides, for example:

When a terminated distributor is entitled to compensation under Subsection (4) of this section, a successor distributor must compensate the terminated distributor for the fair market value of the terminated distributor’s rights to distribute the brand, less any amount paid to the terminated distributor by a supplier or other person with respect to the terminated distribution rights for the brand. . . . A terminated distributor may not receive total compensation under this subsection that exceeds the fair market value of the terminated distributor’s distribution rights with respect to the affected brand.

Thus, Marine View argued that the Act only limits Marine View’s right to seek compensation for the fair market value of its rights for a without-
cause termination, but not for other grievances, such as a common law breach of contract.

The court analyzed whether the Act abrogated the common law in order to provide for an exclusive remedy to distributors terminated without cause. The court held that a statute abrogates the common law when its provisions are “so inconsistent with and repugnant to the prior common law that both cannot simultaneously be in force.” Pabst argued that the Act contains a statement of exclusivity because it limits the terminated distributor’s right to recover the fair market value of the distribution rights from the successor distributor. The court disagreed, noting that the Act allows successor distributors and suppliers to negotiate who will pay the terminated distributor for the fair market value of its lost business. The Act, however, does not affect how a distributor is compensated for lost profits, reputational damages, or reliance damages. The court held that the statute only provides a remedy for the loss of the fair market value of the distribution rights, but not remedies for other common law damages such as lost profits or reputational damages. Therefore, the court granted Marine View’s motion for partial summary judgment, declaring that the statute did not abrogate Marine View’s right to seek common law relief for breach of contract and related damages and that the statute only addresses the damages from the loss of the fair market value of the distribution business.

TERMINATION AND NONRENEWAL


Home Instead, Inc. operates a business that provides non-medical care to senior citizens through a network of more than 1,000 franchises. Home Instead and Elder Care Providers of Indiana, Inc., which was owned by Anthony and Georgette Smith, entered into a franchise agreement pursuant to which Elder Care agreed to operate a Home Instead business in an area of Indianapolis for a ten-year term. Elder Care and other Home Instead franchisees in Indiana are licensed as personal services agencies (PSA), not home health agencies (HHA). A licensed PSA does not require medical staff, and oversight by the Indiana State Department of Health is relatively limited compared to a HHA. A licensed HHA provides skilled nursing and home health aide services authorized by a physician’s prescription or order from other medical professionals and supervised by a registered nurse. The skilled nursing services that an HHA may provide include wound care; drawing blood; injecting prescribed medications; and providing

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\(^1\) Cline Williams Wright Johnson & Oldfather, L.L.P. represented Home Instead, Inc. in _Elder Care Providers of Indiana, Inc. v. Home Instead, Inc._ Editor-in-chief Gary R. Batenhorst, a partner with the firm, edited the entry although he was not directly involved in the case.
medical baths and nursing assessments and diagnoses. HHAs are reimbursed by Medicaid and subject to fairly rigorous oversight. Home Instead franchisees are not authorized to provide HHA medical services.

As a PSA, Elder Care provided non-medical home care and was not allowed to provide any medical care pursuant to both its franchise agreement and Indiana’s license requirements. In November 2011, the Smiths formed Home Again Senior Care, Inc., now known as Purpose Home Health, Inc., which was a separately licensed HHA corporation. Home Again and Elder Care frequently referred clients to one another and shared some employees. Home Instead first learned of Home Again’s operations in March 2013, giving rise to two concerns: (1) the possible confusion caused by the use of the name Home Again and (2) the possibility that Home Again would provide services in direct competition with Home Instead. The franchise agreement prohibited Elder Care and the Smiths from operating, owning, or engaging in any non-medical companionship and domestic care service business that is of the character and concept similar to the Home Instead senior care business or any unauthorized use of the Home Instead trademark.

After learning about Home Again, Home Instead began a twenty-month investigation. Home Instead ultimately concluded that the Smiths’ operation of the Home Again business constituted a breach of the franchise agreement’s non-compete and infringed on Home Instead’s trademark. Accordingly, in November 2014, Home Instead terminated Elder Care’s franchise agreement on three grounds: (1) violating the in-term non-compete; (2) diverting business from Elder Care to Home Again and disclosing confidential information contained in the franchise agreement; and (3) using the name Home Again, which was confusingly similar to Home Instead’s licensed marks. Pursuant to the notice of termination, the termination was to be effective three days from the date of the notice. Elder Care continued to operate as a Home Instead franchise until January 31, 2015, which allowed time for it to wind its business down.

On May 26, 2015, Elder Care’s counsel advised Home Instead that Elder Care was going to sell its client list to a neighboring Home Instead franchisee for $500,000. Home Instead raised various concerns about the legality of the transfer, but did not seek to prohibit the transfer or to unwind the transfer agreement. After the sale of its client list, Elder Care ceased all business operations.

Elder Care filed a complaint in the U.S. District Court for the Southern District of Indiana on November 8, 2014, alleging that Home Instead’s termination of the franchise agreement was a breach of contract and a violation of the Indiana Deceptive Franchise Practices Act and seeking declaratory relief and damages. Home Instead subsequently filed counterclaims against Elder Care, the Smiths, and Home Again for breach of contract, civil conspiracy, misappropriation of trade secrets, unfair competition, and trademark infringement. The parties then each filed motions for partial summary judgment.
Elder Care sought a declaratory judgment that Home Instead had failed to provide proper notice of termination as required by the franchise agreement, Elder Care had not violated the non-compete and non-disclosure covenants in the agreement, Home Instead’s termination was of no legal effect, and the transfer of the customer list was valid and enforceable. Home Instead argued that the termination was based on Home Again’s unfair competition, which justified immediate termination without an opportunity to cure. Home Again claimed that because Home Instead knowingly acquiesced to Home Again’s use of the name “Home Again” for twenty months, Home Instead had waived its right to immediately terminate the franchise agreement and that Home Again did not compete with Home Instead; therefore, there was no violation of the non-compete and no unfair competition. In response, Home Instead argued that it had continued to notify Home Again of the need to change its name during its twenty-month investigation and had not acquiesced to the use of the name Home Again.

The court held that Home Instead’s failure to take immediate steps to terminate the franchise agreement reasonably led Home Again to believe that Home Instead did not intend to terminate the agreement without notice and an opportunity to cure. In other words, Home Instead could not ignore a supposed material breach for a twenty-month period during which Home Instead mentioned from time-to-time that Home Again would have to change its name and then suddenly terminate the agreement without providing an opportunity to cure. The court found that because Home Instead had lulled Home Again into a false sense of complacency for over twenty months by not immediately demanding that Home Again change its name, Home Instead had wrongfully terminated the franchise agreement by not providing notice and an opportunity to cure.

Home Instead also argued that Home Again violated the non-compete in the franchise agreement by offering the same or similar services as Home Instead franchisees. The court noted that although Home Again provided as a licensed HHA some of the same services that Home Instead franchisees provide as licensed PSAs, Home Again was not of a similar character and concept to a Home Instead franchise and was not a competitor of Home Instead. The non-compete expressly prohibited the Smiths from operating a “non-medical companionship and domestic care service business,” but Home Again as an HHA was not doing this and was offering medical services that Home Instead franchisees were not permitted to offer both under their franchise agreements and their state licenses. Therefore, the court held that Home Again had not violated the non-compete restrictions.

Home Instead further argued that because Home Again and Elder Care shared some employees, a reasonable jury could determine that Elder Care disclosed confidential information and trade secrets to Home Again. The court noted, however, that the evidence reflected that persons hired by Home Again were not trained based on Home Instead materials and that Elder Care shared only two documents with Home Again employees, the
time-off request form, which Home Instead did not contend was conﬁdential, and an Elder Care handbook that had been revised and changed from Home Instead’s template to become Elder Care speciﬁc. Therefore, because there was no evidence that any Home Again employee was trained using conﬁdential or proprietary materials belonging to Home Instead, the court granted summary judgment in favor of the Smith parties.

The court ruled against Home Again on its motion for summary judgment on Home Instead’s trademark infringement claim. Home Instead alleged that trademark infringement occurred both before and after termination of the franchise agreement. In denying Home Again’s motion related to pre-termination infringement, the court rejected Home Again’s acquiescence argument, finding that Home Again had not suffered economic prejudice resulting from Home Instead’s delay in asserting its trademark rights. The court also rejected Home Again’s argument that there was no likelihood of confusion. The court noted that Home Again had focused on whether Home Instead could prove actual confusion, but said that courts in the Seventh Circuit have often said that “likelihood of confusion can exist without any evidence of actual confusion.”

In its motion related to post-termination infringement, Home Again argued that any alleged infringement after termination was fair use and that the names in question were not being used in commerce. The court said Home Again did not satisfy the fair use requirements that the use be otherwise than as a mark and be descriptive and used fairly and in good faith to describe the goods or services. The court also rejected Home Again’s in commerce argument, noting certain evidence that the marks were used as a trademark after termination, although the court expressed skepticism that Home Instead suffered appreciable damage from these uses.

The court also denied summary judgment to Home Again on Home Instead’s trademark counterfeiting claim. In the absence of controlling Seventh Circuit precedent on the issue, each side urged the court to follow certain other precedents supportive of their respective positions. The court found the precedent cited by Home Instead to be consistent with Seventh Circuit precedent and said Home Again “cannot escape liability for the use of counterfeit marks on the basis they are a hold-over franchisee.”

Elder Care also sought a declaration that the transfer of its client list to another Home Instead franchisee was valid and did not constitute a misappropriation of trade secrets. Customer lists, however, were clearly identiﬁed as trade secrets and conﬁdential information in the franchise agreement. Thus, the court found that a reasonable jury could ﬁnd that Elder Care’s customer list belonged to Home Instead and that Elder Care sold the trade secret without authorization by transferring it to another franchisee.

Home Instead also argued that because payment for the client list was to be made over several years, the Smiths and Elder Care violated the post-term covenant not to compete by owning or having an interest in a non-medical service business that imitates or operates in a manner similar to a Home
Instead business. The court agreed with the Smiths and Elder Care on this point, noting that the post-term non-compete prohibited the Smiths and Elder Care from having an interest in a business that imitates or operates in a manner similar to a Home Instead business, but here, the Smiths and Elder Care had a financial interest in an actual Home Instead business, not a competitor or imitator.

The Indiana Deceptive Franchise Practices Act prevents franchisors from discriminating unfairly among franchisees and the Smiths argued that Home Instead discriminated against them by allowing other franchisees to offer similar services to those provided by Home Instead through secondary businesses, such as a cleaning company and a transportation company. The court noted, however, that one of the three stated reasons for the termination of Elder Care’s franchise agreement was the wrongful use of the name Home Again that infringed on Home Instead’s trademark. Therefore, even if some franchisees had offered services competitive with the Home Instead system through secondary businesses, they were not similarly situated to the Smiths because the Smiths were terminated at least in part for infringing on Home Instead’s trademark. Therefore, the court granted Home Instead’s motion for summary judgment on the Smiths’ claim for violation of the Indiana Deceptive Franchise Practices Act.


The U.S. District Court for the District of Arizona granted Best Western International, Inc.’s motion to dismiss the plaintiff’s complaint asserting claims related to the allegedly improper termination of the parties’ membership agreement and seeking a declaratory judgment that the plaintiff did not violate the Lanham Act or other applicable federal law for failing to remove Best Western’s trademarks from the terminated hotel in a timely manner.

The plaintiff is the owner of a hotel in Casper, Wyoming. Best Western is a non-profit corporation that operates as a membership association for Best Western branded hotel operators in North America. The plaintiff’s membership agreement with Best Western required the plaintiff to adhere to Best Western’s bylaws, articles, rules, and regulations. The bylaws provide that a member may be terminated if (1) Best Western’s Board of Directors, after a hearing, find grounds to cancel the membership; (2) the Board grants the member an extension to comply with a remedial plan, but the member fails to satisfy the remedial plan; or (3) a member receives two failing quality assurance scores in an eighteen-month period.

In May 2013, Best Western notified the plaintiff that it was considering terminating the parties’ membership agreement because the hotel had received two failing quality assurance scores in an eighteen-month period. The plaintiff requested and received a hearing before the Best Western Board of Directors and, although the Board found grounds existed to termi-
nate the membership, the Board granted the plaintiff an extension requiring that certain conditions be met in a timely manner in order for the relationship to continue. The conditions included the requirement that the plaintiff complete a property improvement plan by March 31, 2014, and that if all improvements were not met by that date, the membership agreement would be terminated. On February 4, 2014, the plaintiff requested additional time to complete the improvement plan and Best Western granted an extension to October 1, 2014. In October 2014, Best Western inspected the plaintiff’s hotel and determined that portions of the improvement plan had not been completed. Nonetheless, Best Western granted a further extension to February 24, 2015. An inspection in March 2015 confirmed that the plaintiff had not completed all requirements of the plan and, as a result, Best Western terminated the membership agreement.

Shortly after Best Western terminated the membership agreement, the plaintiff began to de-identify the hotel. However, Best Western subsequently discovered that some Best Western marks had not been removed and a highway billboard still indicated that the hotel was affiliated with Best Western. In July 2016, the plaintiff filed a lawsuit against Best Western asserting claims for breach of contract and the covenant of good faith and fair dealing, as well as seeking declaratory relief that the plaintiff had not violated the Lanham Act by failing to remove Best Western’s trademarks in a timely manner. In response, Best Western filed a Federal Rule of Civil Procedure 12(b)(6) motion to dismiss.

Because it was a motion to dismiss, the court accepted all allegations of material fact in the plaintiff’s complaint as true and construed the complaint in the light most favorable to the plaintiff. Additionally, although courts are generally not permitted to consider documents beyond the pleadings in a Rule 12(b)(6) motion, courts may consider documents that are submitted as part of the complaint or whose contents are alleged in the complaint even if the complaint does not explicitly reference the document at issue.

The court noted that a claim for breach of contract under Arizona law requires a party to establish (1) the existence of a contract between the parties, (2) the defendant’s breach of the contract, and (3) the plaintiff’s resulting damages. Best Western argued that it terminated the plaintiff’s membership agreement in the manner required by the contract. The plaintiff, however, claimed that it had substantially complied with the property improvement plan, arguing that its total investment in the hotel was more than $4.6 million and it had completed 194 of the 197 items in the improvement plan. Under the substantial compliance doctrine, a party’s substantial performance entitles it to performance from the other party. The plaintiff also argued that following a material breach, the non-defaulting party must either elect to waive the breach and continue performance or terminate the contract and sue for damages, and that because the membership agreement was terminated in February 2015, but the plaintiff was permitted to operate until April 2015, Best Western had accepted performance by allowing the
plaintiff to continue to operate for two months after the property improvement plan deadline and thus waived the right to terminate the agreement. In response, Best Western argued that substantial compliance usually does not apply when the agreement expressly addresses what constitutes a breach and what remedies result from such a breach, and the substantial performance rule does not apply when the parties have agreed that only complete performance will be satisfactory.

The court noted that the circumstances here were unlike a construction dispute where the substantial compliance doctrine often applies because this was not a situation where the plaintiff put up the vast majority of the consideration and the other party avoided paying based on an immaterial breach. Rather, the plaintiff received all of the benefits of the renovations at the hotel that it undertook pursuant to the property improvement plan. Therefore, the court held that the substantial compliance doctrine did not apply, and the contract made it clear that Best Western was entitled to terminate the membership agreement. Accordingly, the court dismissed the plaintiff’s breach of contract claim.

The plaintiff also argued that Best Western breached the implied covenant of good faith and fair dealing by imposing unreasonable conditions and a nearly impossible timeline to complete the property improvement plan, and that it reasonably expected to be given additional time to complete the required improvements so long as it was making adequate progress towards complying with the plan. The court, however, agreed with Best Western that the membership agreement expressly provided a right to terminate if the plaintiff failed to meet the property improvement plan in a timely manner, and that the plaintiff was asking the court to look beyond the plainly written terms of the membership agreement and grant greater rights than it bargained for. Therefore, the court also dismissed the breach of the covenant of good faith and fair dealing claim.

With respect to the claim for declaratory relief that it had not violated the Lanham Act, the court noted that the plaintiff was using the Best Western trademark without Best Western’s consent and that the plaintiff had received Best Western’s express written demand that it cease using Best Western’s marks upon termination of the membership agreement. Therefore, the court also dismissed the declaratory relief claim.


The U.S. District Court for the Southern District of Florida held that a fast food franchisor was entitled to partial summary judgment on its franchisee’s claim for declaratory judgment involving the timing of the franchisor’s termination notice to the franchisee. The court found the notice was timely because the franchisee had actual notice of the default, the franchisee failed to
cure the default in a timely manner, and the cure period expired before the franchisee offered to cure the default.

Tim Hortons USA, Inc. and Panagg Café Incorporated entered into a franchise agreement granting Panagg the right to operate a Tim Hortons store in Irondequoit, New York. Tim Hortons sent Panagg two notices of default on July 7, 2016, after Panagg failed to make its requisite royalty and other payments due under the franchise agreement. One of the notices provided that the franchise agreement would be terminated if the past due amounts were not paid in full within five days of receipt of the notices. Tim Hortons emailed the notices to Panagg’s president, Gurvinder Singh, and also sent them via overnight delivery. Less than an hour after the notices were emailed, Singh presumably opened them and forwarded them to one of his daughters. Singh also telephoned ‘Tim Hortons’ Director of Franchise Performance within an hour-and-a-half of receiving the notices.

Panagg did not offer to cure the defaults until July 13, 2016. That same day, Tim Hortons notified Panagg that the franchise agreement was terminated. Panagg challenged the termination on the grounds that the email notices failed to comply with the franchisee agreement’s notice provisions, which did not specifically provide for notice via email. Tim Hortons subsequently sued Panagg and the latter counterclaimed, including in its counterclaim a count for declaratory relief. Tim Hortons moved for partial summary judgment on Panagg’s claim for declaratory relief arguing that: (1) Panagg received the default notices and consequently had actual knowledge of the pending termination as of July 7, 2016; (2) Panagg’s opportunity to cure the financial defaults expired on July 12, 2016; and (3) Panagg’s proffer of a cure on July 13, 2016, was too late.

Panagg opposed the motion arguing that: (1) its claim for declaratory judgment was intertwined with other claims in Tim Hortons’ complaint and Panagg’s counterclaim; (2) Tim Hortons failed to timely provide individual notices to each of Panagg’s representatives and guarantors; and (3) a course of performance prevented Tim Hortons from sending the notices.

The court granted in part Tim Hortons’ motion for partial summary judgment. As a threshold matter, it noted that Federal Rule of Civil Procedure Rule 56(a) authorizes entry of summary judgment to a part of a claim or defense. Next, it rejected Panagg’s arguments regarding the timeliness and legitimacy of the notices. Citing precedent under Florida law, the court observed that strict compliance with a notice provision is unnecessary if the receiving party has actual notice. Here, the fact that Singh opened the email containing the notices, forwarded it to one of his daughters, called Tim Hortons’ after the notices were emailed, and failed to dispute receipt of the emailed notices all demonstrated that Panagg had actual notice of the two default letters. It also rejected Panagg’s argument that Tim Hortons was required to provide individual notices to each of Panagg’s representatives and guarantors. The court noted that the franchise agreement was between Tim Hortons and Panagg and that the notice provision required only that the no-
notices be sent to the respective parties at the addresses set forth on the signature page of the agreement. Here, that meant that the notices only had to be sent to the company and addressed to the attention of all three guarantors. The emailed default notices had been addressed to Panagg and to the attention of the three guarantors. Moreover, because the guarantee provided that the guarantors waived notice of demand for payment or performance, Tim Hortons had no contractual requirement to provide individual notice to the guarantors.

The court denied the portion of Tim Hortons’ summary judgment motion that related to Panagg’s course of performance challenge. Pursuant to a declaration made by Singh, Panagg had been making weekly payments to Tim Hortons through ACH withdrawals from Panagg’s bank account. The day that Tim Hortons emailed the default notices to Singh, an accounts receivable administrator for Tim Hortons’ parent company sent Singh a weekly email regarding amounts due. Singh was told the total amount due and was asked what he could pay that week. After Singh stated that he could pay only a portion of the outstanding amount, Tim Hortons took out that portion a few days later. Thus, there was a genuine issue of material fact whether a course of performance prevented Tim Hortons from sending the default notices. The court did not address whether Tim Hortons had adequate grounds to send the default notices and whether the franchise agreement had been properly terminated.

TORTIOUS INTERFERENCE

This case is discussed under the topic heading “Damages.”

TRADEMARK INFRINGEMENT

This case is discussed under the topic heading “Damages.”

This case is discussed under the topic heading “Injunctive Relief.”