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From the Editor-in-Chief

Daniel J. Oates

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As many of you may have noticed, I have devoted this space to a wide variety of topics during my short tenure. The eclectic mix of author recruitment, forum cheerleading, and pure editorializing may seem to be a calculated effort to keep your interest; something that has always been a challenge given the extremely poor marks that have historically been attached to the EIC’s editorial column. The more astute of you have probably also surmised that the constantly changing lineup of topics littered with frivolous pop culture references is most likely a selfish attempt by me to keep myself entertained. The answer undoubtedly lies somewhere in the middle.

Today, however, I would like to spend a little bit of my nonexistent reader political capital on a true editorial subject that I hold dear to my heart: civility. Civility is a complex concept that gets thrown around regularly in legal circles, but it is either sadly misunderstood, or (more often) simply ignored as an idealized standard from a bygone era that has no place in the bare-knuckle, free-for-all, battle royale that so pervasively permeates our current culture. I should preface these remarks by stating that I am in fact quite proud that the community of attorneys that comprises the American Bar Association’s Forum on Franchising is an exceedingly cordial bunch. In general, our membership exhibits an inordinately high degree of professionalism, along with respect for the dignity of our respective brethren.

1. I am surprised on a daily basis that the membership has not broken out the pitchforks and torches and demanded my head as recompense for my vanity in these columns. Your restraint in the face of my continued expressions of absurdity is admirable.

2. ABA Forum on Franchising, 2016 Member Survey Results 26 (2016) (“Feature articles are most frequently read in the Franchise Law Journal; the Editor’s Column is the least read item.”). I am very disappointed in all of you.

3. Or, and I’m just spit-balling here, most definitely the selfish one.
This cordiality is all the more surprising given the widespread belief among many attorneys in our practice that, rightly or wrongly, the benefits of franchising are a zero-sum calculation. As such, many view franchising as if it is some titanic, tension-filled struggle between two kaiju where only one can ultimately prevail, rather than a collaborative negotiation between partners. Consequently, it is shocking how so many franchise disputes are resolved far in advance of litigation, and it is a credit to our bar. Part of this is undoubtedly attributable to the relatively diminutive size of our community of attorneys. As any veteran of the criminal bar can attest, courtesy and professionalism are much easier to maintain when you know that you are likely to be stuck litigating against the same attorney again on future cases. Today’s denied courtesy to the other side may be tomorrow’s folly when you need a courtesy in return.

All of this being said, there is always room for improvement. Franchising, although a somewhat niche practice, is often national. As such, it does not lend itself to the type of self-regulation of conduct that you often see when attorneys have hyperlocal practices that require constant interaction with same judges and counsel. Instead, a national practice means it is likely that an attorney will rarely be in the same court twice, rarely in front of the same counsel. And recent experience has shown that we are not immune to the type of vitriol and unprofessionalism that are so common in the ranks of our general litigation colleagues. A recent disagreement on the forum’s listserv escalated to the point where the principal actors challenged one another to a duel and began receiving volunteers for seconds.

“So uncivilized.”

While this was all undoubtedly in jest, it betrays an ugly undertone to our discourse that cannot easily be dismissed. In an era where every e-mail, text, and social media post are recorded for all posterity and can be dredged from the depths of the web at any time, we must be all the more vigilant and circumspect in our interactions. This is not only an appeal to your self-interest;
it is the right thing to do. Anyone who has not disgraced their honor by resorting to bigotry or prejudice deserves to be accorded dignity and respect in a professional community such as ours.

None of this means that lawyers cannot continue to be zealous advocates for their clients. Civility does not mean that attorneys cannot have that “edge” that our clients sometimes need. It does not mean that strenuous disagreements will disappear, and it does not mean that we cannot take extreme positions when the occasion demands it. But our disagreements must not devolve into personal attacks, vitriol, or unfounded accusations. I, for one, expect more, and you should as well.

Civility and courtesy may sound a little old-fashioned in the era of twitter spats, road rage, and Internet trolls. But sometimes “people might just need a little old-fashioned.” Our institutions and tradition are the glue that bind our communities, and, in an age of hyper-partisan bickering and ever expanding litigation, they are all the more critical to preserving our humanity and enshrining our values and way of life for future generations. If you are ever tempted to send that harshly worded response to an opposing attorney who crossed a line, I strongly encourage you to engage in self-reflection before doing so. If that means sleeping on it, or running it by a colleague, then do it. There is nothing more regret-inducing than sending an improvidently written e-mail in response to a rage-inducing message from opposing counsel. Conversely, I have found that every time I take the high road in a disagreement, I never end up regretting the decision. And neither will you.

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8. Except perhaps an improvidently written e-mail that is sent with an inadvertent use of the reply-all function. Despite its obvious utility, I’m quite certain I remember reading somewhere in Dante’s Inferno that there is a specific circle of hell for the inventor of the reply-all, along with telemarketers and whoever invented that impossible-to-cut clam shell plastic. Trust me, it’s in there. You don’t need the pincite.
Item 8 Rebate Disclosures for the Modern Supply Chain

Robert G. Huelin & Sawan S. Patel

Not long ago, during a panel on Franchise Disclosure Document (FDD) disputes, the panelists posed a hypothetical as time was winding down: “If a franchisor is buying inventory from a supplier and gets a rebate on its purchase, is that subject to disclosure?” The majority of those present quickly answered “Yes,” much to the surprise of the panel. The session ended very shortly after; there was no time for a thorough discussion of the issue and the consensus in the room went unexamined. This result was actually quite reflective of the extant writing and thinking regarding Item 8 of the Amended Federal Trade Commission Franchise Rule (Rule)—which is to say, a broad conclusion in favor of disclosure without extended analysis.

While the conclusion of disclosure is easy enough to reach, the work of counsel in support of supply chain and supplier management is actually more complex. Business leaders in a supply chain are often engaged in a rapid-fire process that is increasingly driven by technology rather than deal-making. Franchisor counsel may need to offer opinions on rebates, discounts, and supplier choices that impact millions of dollars in sales and profits. Any counsel hopeful of providing comprehensive and meaningful advice must have a strong understanding of what Item 8 actually says and how it applies to the often labyrinthine workings of the modern supply chain.

In this article, we review the history and purpose of Item 8, the elements of required disclosure, and certain additional issues and risks raised by both supply chain practices and Item 8.

1. 16 C.F.R. § 436.5(b).
I. A Brief History of Supply Chain Disclosure

Franchisors usually find it necessary to provide their franchisees with quality products from suppliers they have vetted and trust. Franchisors also find it indispensable to ensure that franchisees are using trademarked goods and services (both to ensure the health of the marks and to maintain brand standards). Franchisee needs and interests (and ingenuity and entrepreneurship) are also important, and a franchisor must consider how to best utilize these to the benefit of the system. And, of course, the franchisor needs to make money for itself. These aims are often in tension, especially in the supply chain where the franchisor has a strong interest in taking advantage of the buying power represented by the franchisees.

Recognizing that franchisors may not always heed the better angels of their nature when accommodating these competing interests, and concerned that franchisees may be at risk from predatory purchasing rules or non-competitive supply chain practices, the Rule has long included a requirement that franchisors disclose their (and their affiliates) interest in, and benefits derived from, suppliers and supplier relationships. The supplier relationship disclosure was more limited in the prior version of the Rule, focused on identifying the parties and the existence of benefits for the franchisee, without details. The 1994 version of the disclosure called for (1) “the name of each person (including the franchisor) the franchisee is directly or indirectly required to do business with by the franchisor”; (2) a list of any “real estate, services, supplies, products, inventories, signs, fixtures, or equipment relating to the establishment or the operation of the franchisee business which the franchisee is directly or indirectly required by the franchisor to purchase, lease or rent”; (3) a list of the names and addresses of the persons from whom those required purchases must be made; and (4) a “description of the basis for calculating, and, if such information is readily available, the actual amount of, any revenue or other consideration to be received by the franchisors” as consideration from the suppliers who benefit from the required purchases.

The objective of this disclosure was on the identity of the supplier, with the implicit assumption that the prospective franchisee would conduct its own research into the details of the purchasing requirements by contacting the suppliers directly.

The 1994 version of the Rule did not offer much information to franchisees regarding the nature of the relationships between the franchisor and its suppliers, and it did not give much detail about alternative supply possibilities. Accordingly, during the Federal Trade Commission’s (Commission) review of the Rule prior to its ultimate revision of the Rule in 2008,
a special concern raised in comments by franchisee counsel was profiteering, whereby franchisors were arguably making franchisees uncompetitive by forcing them to pay premium prices for goods from franchisor-controlled suppliers when viable (and cheaper) alternative products or suppliers were available.7 Franchisee counsel voiced concern about source restrictions that prevented franchisees from obtaining supplies at lower market rates and noted that franchisors failed to approve alternative suppliers or made it difficult for franchisees to find alternative sources of supplies.8 Generally, the allegations were not about franchisors’ failure to disclose source restrictions but rather about the “abusive nature” of such restrictions.9 The Commission was also urged to expand the disclosure of supplier restrictions to require franchisors to disclose more information about their practices and intentions with respect to the provision of competitive alternative sources of supply.10

Commenters to the original Rule also raised the issue of financial transparency. Franchisee advocates suggested that franchisors should disclose the dollar amount of any revenues received from suppliers during the last year, and some even urged the Commission to prohibit direct and indirect “kickbacks” from third party vendors of the franchisor.11 Ultimately, this disclosure was meant to serve an “anti-conflict of interest” purpose to put franchisees on notice that the franchisor is benefiting materially from a relationship with the supplier, which may be a motivation to require franchisees to obtain goods or services from certain suppliers without regard to potential competitive advantages for the system or cost control for the franchisees.12

The Commission’s revisions to the Rule in 2008 focused on achieving a “full disclosure of source restrictions and purchasing obligations” to “inform prospective franchisees about critical restrictions on how they will have to operate the franchise.”13 To that end, the revised Rule required disclosure of “the criteria for approving suppliers available to franchisees” and whether “the franchisor provides material benefits to franchisees who use designated or approved suppliers.”14 The Rule also added disclosures regarding negotiated pricing and the existence of “purchasing or distribution cooperatives.”15 Financial disclosures were not expanded as significantly as relationship disclosures. Although the “feasibility” standard for financial disclosure was eliminated, the Commission did not emphasize the disclosure of actual

8. Id.
10. Staff Report, supra note 7, at 80.
11. Statement of Basis and Purpose, supra note 9, at 15488.
12. Id.
13. Id. at 15487.
14. Id.
15. Id. at 15549.
amounts of revenue or the value of benefits received, instead stating that “the highly material fact is that the franchisor receives revenues from suppliers it requires franchisees to use, not the exact dollar amount received.”

Hence, the Rule requires disclosure of revenues and benefits from suppliers solely as a percentage of total revenues rather than insisting (as the older Rule did) on providing actual amounts of revenue where possible.

II. Item 8 Disclosure Requirements

A. Current Rule

The current Rule begins with an overarching statement of the disclosure for the franchisee’s obligation to purchase or lease certain types of goods required for the franchised business. Franchisors must disclose in Item 8 the following:

the franchisee’s obligations to purchase or lease goods, services, supplies, fixtures, equipment, inventory, computer hardware and software, real estate, or comparable items related to establishing or operating the franchise business either from the franchisor, its designee, or suppliers approved by the franchisor, or under the franchisor’s specifications. Include obligations to purchase imposed by the franchisor’s written agreement or by the franchisor’s practice.

This provision is dense and requires careful examination to determine the extent of the necessary disclosure. To begin, note that a franchisee’s purchase from the franchisor or the franchisor’s preferred supplier does not automatically create a disclosure obligation. The Commission’s Franchise Rule Compliance Guide (Guide) states that “Item 8 covers only required purchases and leases of goods and services that are source restricted, meaning that the franchisee must make the purchases from a specific supplier or limited group of suppliers . . . .” Thus, a disclosure obligation arises only if there is a mandate from the franchisor that creates an “obligation.” The Guide clarifies that the current Rule is focused on restricted source supply chains, regardless of whether the franchisor has a stake in the purchases and regardless of whether the franchisee requires the product to operate the business.

This is a critical point when analyzing any supply arrangement under the Rule to determine if it creates an “obligation.” For example, under the 1994 Rule, if the franchisor requires the franchisee to sell drinks-to-go and, as a result, the franchisee must purchase straws and the franchisee purchases those straws from a supplier approved by the franchisor, the franchisee’s obligation to purchase straws is covered by Item 8.

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16. Id. at 15488.
17. Id.
18. 16 C.F.R § 436.5(h).
20. Surprisingly “obligation to purchase or lease” is not defined in the Rule, and this omission was purposeful. The Commission decided that the phrase, which was present in the pre-2007 UFOC Guidelines, had “not previously raised any interpretive issues” and therefore that no further definition was needed. Statement of Basis and Purpose, supra note 9, at 15488 n.460. This decision did not consider the effect of the changes in the scope of the disclosure, which does, or should, raise interpretive issues for franchisor counsel.
straws from a franchisor-owned source at a substantial mark-up, a disclosure was plainly required. But, while the need to buy straws is arguably “imposed by practice” under the current Rule, it is not an “obligation,” even with the mark-up and the franchisor’s ownership of the seller, unless the franchisor explicitly requires the purchase of the specific straws sold by the franchisor or otherwise limits the sourcing of straws to only the franchisor-owned supplier or a designated group of suppliers that included the franchisor-owned supplier.

As the mere fact of a franchisee-franchisor supply transaction does not trigger disclosure, it is incumbent on counsel to dig deeper into the structure of the supply chain relationships. The Rule—though lacking a clear definition—does provide the elements of a test to ascertain the existence of an “obligation” according to the purpose set forth by the Guide. This test has two parts: first, determine if the source of the product is enumerated in the Rule as a disclosable source, and, second, determine if there is a written or practical restriction on the use of alternate sources imposed by the franchisor.

The Rule identifies four potential categories of disclosable sources: (1) the franchisor, (2) a designee of the franchisor, (3) a supplier approved by the franchisor, or (4) a supplier acting under the franchisor’s specifications. If the supplier is an eligible supplier, then we must determine if the franchisor has created a restriction on the relevant product supply (or a restriction in favor of the relevant supplier), either enshrined in a written agreement or by virtue of the business practices of the franchisor or the franchise system.

We will review each element of this standard.

B. Who Is the Eligible Supplier?

Determining if the seller is in a disclosable category is, and ought to be, the first and easiest part of determining if a supply chain relationship triggers a disclosure obligation. Most obviously, if the franchisor sells or leases products or services directly to franchisees, or if an affiliate of the franchisor sells or leases products or services, then disclosure may be necessary.

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21. Disclosure was also required under the 1994 Rule if a purchase was “indirectly required” or if the franchisee was “advised to do business” with a franchisor affiliate. 16 C.F.R. § 436.1(a)(9) (1994).

22. Id. § 436.5(h).

23. There is a requirement that the franchisor disclose if it profits from the sales of any supplies to the franchisees, but this applies only if the purchase is “required,” which means the result of an “obligation.” As discussed below, if the franchisee elects to buy from the franchisor without coercion, then no disclosure is necessary even of profits from sales by the franchisor to the franchisees. Id.

24. Id.

25. Id.

26. “Affiliate” is defined as “an entity controlled by, controlling, or under common control with, another entity.” Id. § 436.1(b). This is a commonly used definition for “affiliate” that should be understood to include any parent company, sister company, subsidiary, or joint venture entity owned in whole or in part by the franchisor or any parent, sister, etc. What is less clear is whether an entity in which a franchisor has a minority interest (or where the franchisor’s individual owner—if the franchisor is closely held—holds such a minority interest) is an affiliate. The key test under the definition is “control,” and counsel should focus on whether the entity is subject to the actual control of the franchisor or whether it is merely an investment
Similarly, if the franchisor has designated approved or preferred suppliers, or designated one or more exclusive suppliers, then disclosure may be necessary.

Note that even this seemingly simple assessment can raise questions. The Rule assumes that the franchisor has designated the preferred supplier or that the franchisor controls the preferred supplier. If, for example, the franchisor hands responsibility for developing products to the franchisees, or to a franchisee purchasing cooperative, then it may not be the case that even a preferred supplier is a “designee” of the franchisor. If such cases, the degree of restriction applicable to the franchisees regarding the selection and use of a given supplier will need to be established under the second part of this test to complete the analysis.

C. Is There a Written Agreement or Common Practice Dictating Franchisee Purchases?

An obligation imposed by the franchisor’s written agreement is relatively easy to understand. Historically, many franchisors specified in writing that the franchisees must purchase particular products (often marked with the franchisor’s trademark) and then designated the entity from which those products were to be purchased. Often the franchisor owned some or all of the product supplier(s) or made a profit from the sale of such goods to the franchisees by either selling the goods at a markup or through rebates. If counsel determines that the franchisees will be told in writing that they must buy all paper drink cups from Cup Company X, and that the cups will bear the franchisor’s logo, then disclosure will surely follow.

27. For example, in some franchise systems, the franchisor allows its franchisees to develop their own unique products or services (within certain parameters) and then is faced with the question of whether to scale up or incorporate supply of the products or services if other franchisees want to adopt the same products or services. In other instances, franchisees may push their franchisor for the use of a particular supplier or to permit the sale of a certain product or service system-wide.

28. 16 C.F.R. § 436.5(h).

29. The 1994 Rule was much more focused on transactions with the franchisor or its affiliates. The disclosure included only suppliers that the franchisee was “directly or indirectly required or advised to do business with by the franchisor, where such persons are affiliated with the franchisor.” 16 C.F.R § 436.1(a)(9) (1994) (emphasis added). The “advised to do business” language makes the scope of the pre-2007 disclosure much broader than the “obligated” language in the current Rule, but only within the narrow frame of purchases from entities affiliated with the franchisor. Unrelated third-party supplier sales are now plainly within the scope of the Rule.

30. Such disclosure is required unless the purchase obligation is part of the opening of the franchise and the costs are covered under the initial franchise fee, in which case it is excluded from Item 8. Guide, supra note 19, at 52.
Today, many franchisors are electing not to require the purchase of specific goods or the use of specific suppliers, opting instead to allow the franchisees to pursue generic products or to pursue a variety of sources to ensure competitive pricing. The increased use of market-based supply chains has many causes. Some franchisors may deal primarily in comestibles that can be easily purchased on the open market as fungible goods without a risk to the quality or consistency of the customer experience. Perhaps the franchisor may be a dealer in licensed products manufactured by third parties under their own trademarks and purchased in an open market. Or, the franchisor may have licensed its marks to a purchasing cooperative and empowered the franchisees to choose their own suppliers. It may be that the franchisor is courting multiple suppliers and forcing them to compete against each other for system business as a means to avoid product shortages or to drive down prices. Regardless of the exact reason, fewer franchisors now own and operate a closed supply chain than in the past, and the result is that more and more supply arrangements must be analyzed under the “practice” standard.

As with the key term “obligation,” the Rule does not define the very broad concept of “franchisor’s practice.” The Commission gave some commentary on this question in Footnote 460 in the Statement of Basis and Purpose, “at the very least ‘franchisor’s practice’ may include purchases that are recommended by the franchisor, or purchases that are prevalent among the franchisees, even if not required by contract.” A facile reading of this footnote would include virtually everything that a franchisee purchases under a “recommendation” standard; however, as discussed herein, the threshold for disclosure under Item 8 is requirements, not recommendations.

What, then, constitutes a “practice” that imposes an obligation? The Guide specifically calls out “requirements in the franchisor’s operating manual.” Presumably, if the franchisor mandates the use of trademarked products and then licenses only one or a limited number of suppliers, this would be a restrictive “practice” sufficient to create an obligation. However, if the franchisees have total discretion to purchase or lease items from any source, but elect to purchase them from the franchisor, such purchases need not be disclosed in Item 8. Thus, the franchisor can designate preferred suppliers without disclosure, provided that it does not mandate that the franchisees purchase from those suppliers. Further, the franchisor can use its purchasing power to achieve below-market prices, or secure below market pricing by

31. Statement of Basis and Purpose, supra note 9, at 15488 (emphasis added).
32. See notes 18 to 20, and accompanying text.
34. Id. Neither the Rule nor the Guide states whether a franchisee-designated supplier obligation must be disclosed. As in the above example, if a franchisor licenses its trademark to a franchise association or purchasing cooperative, then even if the result is a restricted supply chain, it is not clear that a disclosure is required. Arguably, if the franchisor approves or authorizes the restriction, even if formally undertaken by the franchisees through an association or cooperative, then there is a “designation” under the Rule. Certainly, there is a “practice” that would have a real impact on the operations of a franchisee, and it would be within the spirit of the Rule to disclose this arrangement.
offering a preferred supplier designation, but if the franchisees are free to seek out market opportunities, then no disclosure is necessary.\footnote{This raises the question of why any franchisor would restrict sourcing unless it was absolutely necessary. A franchisor that permits its franchisees to utilize the open market still retains sufficient power, in terms of forecasting and leveraging system-wide purchasing power, to create lucrative supply relationships for generic goods but has no obligation to disclose either the existence of such relationships or the benefits derived therefrom.}

Additionally, while the Rule may permit a franchisor to restrict the supply chain, a few states impose conditions on sourcing and supplier selection. For example, Indiana makes it unlawful for a franchisor to require franchisees to purchase products or services exclusively from the franchisor’s designated suppliers when products or services comparable in quality are available from other sources.\footnote{Ind. Code § 23-2-2.7-1(1).} Alternatively, in Hawaii, franchisors are allowed to designate suppliers if the purchasing requirement is “justified on business grounds.”\footnote{Haw. Rev. Stat. § 482E-6(2)-(2)(B).} Further, Washington permits a franchisor to restrict the suppliers from which its franchisees must purchase, provided that such restrictions are necessary for business purposes.\footnote{Wash. Rev. Code § 19.100.180(2)(e).} Again, franchisors should carefully consider the actual need to restrict sourcing before electing not to use an open supply chain.

\section*{D. Specific Disclosures}

If both parts of the test for disclosure are met, then the franchisor must provide a host of specific details regarding the supply chain. As explained in the Guide, the purpose of this requirement is to ensure that the franchisor discloses “obligatory purchases, restrictions on sources of products and services, and the amount of revenue franchisors may receive from required suppliers.”\footnote{Guide, supra note 19, at 51.}

The Rule identifies eleven specific categories of information that must be disclosed, if applicable: (1) the identity of any goods or service that must be purchased, leased, etc.; (2) whether the franchisor, or an affiliate of the franchisor is \textit{an} approved supplier or \textit{the only} approved supplier of the good or service; (3) whether any supplier is owned in whole or in part by the franchisor or an officer of the franchisor; (4) the process for approving or revoking the approval of a supplier; (5) whether the franchisor issues specifications and standards to franchisees, sub-franchisees, or approved suppliers and the process for issuance and modification of those standards; (6) whether the franchisor, or its affiliates, \textit{will or may} derive revenue or other material consideration from required purchases by franchisees; (7) the estimated proportion of these required purchases by the franchisee to all purchases and leases by the franchisees of goods and services used in establishing and operating the franchise; (8) payments from a designated supplier to the franchisor “from franchisee purchases;” (9) the existence of any purchasing cooperatives; (10) the process for approving or revoking the approval of a supplier; (11) whether the franchisor, or its affiliates, \textit{will or may} derive revenue or other material consideration from required purchases by franchisees; (12) the estimated proportion of these required purchases by the franchisee to all purchases and leases by the franchisees of goods and services used in establishing and operating the franchise; (13) payments from a designated supplier to the franchisor “from franchisee purchases;” (14) the existence of any purchasing cooperatives;
(10) whether the franchisor negotiates purchase arrangements with suppliers, including pricing, for the benefit of franchisees; and (11) whether the franchisor provides material benefits to a franchisee based on the purchase of products and services from particular suppliers. ⁴⁰ Let’s consider each of these in turn.

1. Goods and Services

The first category of information, the list of goods and services, formally includes only those that are subject to a restricted supply chain. ⁴¹ However, we recommend as a best practice that franchisors disclose all “required” goods or services “related to establishing or operating the franchised business,”⁴² even if disclosure may not be strictly necessary. For example, if the franchisor requires its franchisees to use a point-of-sale system, and that system requires the use of a computer, and the computer must meet certain standards, but the franchisee can purchase it at any local retailer or wherever else it likes, then disclosure is arguably not required. Similarly, if the computer is source restricted but included in the initial franchise fee, then disclosure under Item 8 is not necessary. In practice, however, it is consistent with the spirit of the Rule and the Guide to identify in Item 8 all such necessary goods and services, even if further disclosures and details are not required.

Note that while we recommend a comprehensive list of what may be “required,” we do not suggest that the franchisor offer justifications for any listed item. Although the Guide permits the franchisor to “explain in Item 8 the reason for any particular purchase requirement,”⁴³ there is little to be gained by using the FDD for this purpose, and much risk of incidentally disclosing strategic or confidential information that informs the setting of brand standards and the structure of the system supply chain.

It is also necessary to disclose the “estimated proportion” represented by “required” purchases of all purchases the franchisees must make “of goods and services in establishing and operating the franchised business.”⁴⁴ The Rule provides no guidance on how the franchisor should determine the expected total purchases necessary to establish or operate the franchise business in excess of the “required” purchases (which are exclusive of initial purchases, which ought to be included in the total purchases). We recommend that franchisors utilize the purchases of a corporate-owned store as a point of comparison, if possible, or make a reasonable estimate based on reporting available from franchisees.

⁴⁰ 16 C.F.R. § 436.5(h)(1)–(11).
⁴¹ Guide, supra note 19, at 52.
⁴² 16 C.F.R. § 436.5(h).
⁴³ Guide, supra note 19, at 52.
⁴⁴ 16 C.F.R. § 436.5(h)(7).
2. Franchisor Relationship to Suppliers

It is easy enough to state if the franchisor is one of, or the only, supplier of any goods and services. Most franchisors have affiliates, either holding companies or sister companies, that act as independent sources of supply. In such cases, the franchisor should identify the nature of its relationship with the supplier, the degree of source restriction or exclusivity enjoyed by the supplier, and the goods and services which must be purchased from that supplier. Additional disclosures will also be required for these affiliates that provide products or services to franchisees in Item 1.

3. Ownership Interest in Suppliers

As with the list of goods, the Rule expands its scope in this area to encompass any business in which a broad swath of franchisor personnel may have some interest. “Officer” is defined in the Guide (not the text of the Rule) to include any person with management or policy-making authority. At a minimum, the franchisor should disclose interests held by any individual included in Item 2, as this should encompass all of the persons relevant to the definition of “officer” used by the Guide, though this is broader than the common meaning of that word.

The ownership “interest” that triggers disclosure covers “any percentage of direct ownership from which the officer derives income or other financial benefits.” The Rule requires the disclosure of any interest held by an officer in any supplier, and there is no safe harbor for de minimis or non-controlling ownership of a supplier. Yet, in contrast to the plain text and the lack of a safe harbor, the Commission’s guidance is that “[a] de minimis ownership interest that would not be “material” to an investment decision by a prospective franchisee need not be disclosed.” Franchisor counsel are left to their own judgment regarding what is or is not a “material” interest that must be disclosed. Consistent with the Commission’s FAQ No. 18, we recommend disclosing direct, controlling, or significant interest in any supplier; other, perhaps less direct interests must be analyzed to determine if they would be “material” according to the standard of interest to a prospective franchisee.

It is frankly unclear why no clearer definition of “materiality” has been provided. At present, the Guide creates a broad disclosure that stretches the meaning of “officer” and “interest” in order to capture only arguably immaterial minority interests in third-party companies. Nor is there any real need to capture ownership interests in the form of passive shareholding, even if

45. Id. § 436.5(a).
47. Id.
48. FTC Amended Franchise Rule FAQ’s, supra note 26. “[T]here can be no fixed “threshold” level of ownership that would uniformly provide a safe harbor for officers with a financial interest below a specified level.” Id.
49. Id.
50. “Generally, it can be said that the more direct an officer’s ownership interest is . . . the more likely it is that the staff would deem the ownership interest to be material.” Id.
direct, because other legal safeguards exist to prevent material conflicts of interest. For example, in many public companies a code of ethics would prevent an individual in a position of relevant authority from having an interest in a supplier or other contracting party. And the Rule itself includes a separate disclosure requirement for situations where the franchisor or its leadership has a controlling interest in a supplier and there is a risk (from the franchisee's perspective) that a conflict of interest exists. The Commission, based on its guidance and FAQ No. 18, appears to recognize the limited utility of the broad language applicable to this issue, but nevertheless leaves the burden of interpreting “materiality” and the risk of error on the franchisor.51

4. Approving Alternate Suppliers

The process by which franchisors approve or deny requests from franchisees for new suppliers was of special concern to franchisees when the pre-2007 Rule was reviewed and revised. Franchisees requested, and the Commission agreed to require, a large amount of information regarding the selection, approval, and revocation of alternate sources of supply.52 The franchisor must state (1) whether it shares its criteria for selecting suppliers with the franchisees; (2) whether it allows franchisees to independently contract with suppliers who meet the criteria; (3) whether there are fees payable by the franchisees to secure approval of an alternate supplier, and what process the franchisee must follow to request approval; (4) the time period for notice to the franchisee of a decision regarding a request for approval;53 and (5) if and how the franchisor may revoke an approved supplier once approval is given.54

We recommend that, if a franchisor does allow for franchisees to choose suppliers or to pursue new suppliers, it also publish the criteria for selection and approval, including timetables, to the franchisees. If the franchisor is sincere in engaging the franchisees in the supply chain process, a shared understanding of expectations and process will prevent conflict and likely result in a more efficient and effective supply chain. As there is no obligation to allow alternate suppliers or to publish the criteria for supplier selection, a franchisor

51. “Franchisors therefore would be well advised, in assessing the materiality of an officer’s interest, to err on the side of disclosure.” Id.

52. These disclosures, however, do not need to include proprietary or confidential information or sensitive strategic considerations, such as the exact basis for choosing a product or supplier. As the Staff Report states, “[A] franchisor need only disclose the general process for approving or disapproving alternative suppliers, but not the exact selection criteria themselves.” Staff Report, supra note 7, at 81.

53. The length of time for reviewing requests for alternate suppliers was a key focus for franchisee lawyers during the Rule review. Horror stories were offered of franchisors taking more than a year to respond to a request for supplier approval, effectively killing such requests by tabling them. The Commission offered the disclosure of the window within which a decision will be made, without establishing limits on the time for review or forcing the disclosure of the timetable for review. Statement of Basis and Purpose, supra note 9, at 15487 n.456.

54. 16 C.F.R. §456.5(h)(4)(i)–(v).
that wants to maintain strict control should avoid creating a false impression and provide a general negative response on this issue in the FDD.

5. Specifications, Standards, and Modification

The franchisor must disclose whether it issues specifications and standards for goods and services to franchisees or suppliers, and the means it uses to issue and modify such specifications and standards. This is a simple disclosure, and we recommend that franchisors provide a general statement that it does have specifications and standards for its products and services and how it communicates the same. A reservation of the right to modify and a description of how those modifications are communicated are also a must.

6. Revenue Disclosures

One of the core purposes of Item 8 is to notify franchisees that the franchisor may derive revenue, sometimes significant revenue, from sales of products and services to franchisees. Many franchisors actually make more from the sale of products and services to franchisees than royalties or other typical Items 5 and 6 fees. Arguably, the goal of the disclosure is to notify a prospect if the franchisor actually makes more of its revenue from sales to a “captive audience” than from franchise fees derived from franchisee sales, or if the franchisor will value revenue from sales at the expense of competitive advantages in the cost of goods. Accordingly, while the directive to disclose revenues from product sales and leases is broad, it is not well defined and, like the concept of “required purchases,” ultimately applies to only a narrow slice of potential revenues.

Two elements to the disclosure of revenue streams arise from the supply chain. The first involves a general disclosure of total franchisor revenues from franchisee purchases/leases, and the second covers payments from third-party suppliers to the franchisor.

The disclosure of total revenue requires a potentially complicated inquiry to determine what counts as revenue. First, we must establish that there is a “required” purchase (as discussed earlier, this means a restricted source purchasing obligation) for franchisees. Second, we must determine that there is a disclosable form of consideration. Third, the consideration must be paid to the franchisor or its affiliates. Finally, the consideration must result “from required purchases or leases by the franchisees.”

55. It would be very unusual for a franchisor to have no standards or specifications relevant to any goods or services that the franchisees may purchase. As with the first element of the disclosure, a good-faith attempt to comply with the Rule necessitates some description disclosure under this provision.

56. Staff Report, supra note 7, at 80.

57. 16 C.F.R. § 436.5(h)(6).

58. Id. § 436.5(8).

59. Id. § 436.5(h)(6).
When deciding if there is a disclosable consideration, counsel must begin with the Rule. The plain text of the Rule is, to be blunt, unfeasibly broad: “whether the franchisor or its affiliates will or may derive revenue or other material consideration from required purchases or leases by the franchisees.” Although the word “may” implies the possible need to estimate revenues, the FTC has not interpreted the Rule this broadly, and franchisors may disclose only actual revenues received along with a general description of the potential sales or leases that supply the revenues disclosed without tying specific amounts of revenue to specific sales or leases.

Once we have narrowed our review to actual consideration, we are still forced to define what constitutes “revenue” or “other material consideration.” Direct payments of money from the franchisee to the franchisor or an affiliate is, of course, disclosable revenue. For most franchisors direct payments from franchisees is the sole, or at least the largest portion of, revenue to be disclosed. The next most common source of revenue is certainly payments from a third-party supplier—again, money payments are clearly revenue.

But is there revenue if the franchisees are not subject to a restricted supply chain structure? The answer appears to be no: if the threshold requirement of a restriction on supply is not met, then the payments from franchisees are not subject to disclosure. Nor would payments to a franchisor from a supplier, even if arising out of franchisee purchases, need to be disclosed if the purchases are not made under a restricted supplier arrangement. Accordingly, even if the franchisor takes a broad approach to identifying goods that might be subject to specifications or restrictions, there is no corresponding revenue to disclose unless an actual restriction is in place such that the franchisee purchases are not “optional.”

Thus far, we have reviewed cash payments, but other forms of “material consideration” may need to be valued and included in the revenue disclosure, although it is unclear that this is actually required. Among such potential benefits are discounts, rebates, and bartered goods and services (including for the benefit of corporate-owned outlets). If these benefits are subject to inclusion in revenue, the issue of valuation may not be easy to resolve.

60. Id. § 436.5(h) (emphasis added).

61. The Guide makes clear that only an aggregate statement of revenue, taken from the franchisor’s audited financial statements, is required. Guide, supra note 19, at 54–55. This is consistent with the Guide’s direction on payments from third-party suppliers that “[p]ayments to franchisors from suppliers may be disclosed either as a percentage or as a flat dollar figure on an aggregate, not individual supplier basis.” Id. at 55. The logic applies to revenues from payments franchisee purchases, despite the Rule stating that disclosure includes “revenues from all required purchases and leases of products and services” without differentiating between aggregate or specific revenues. 16 C.F.R. § 436.5(h)(6)(ii).

62. For the purposes of this discussion, we assume that all consideration is delivered to the franchisor or its affiliates. Any consideration that is delivered to the franchisees is outside the scope of the disclosure, but drawing this distinction should not require legal analysis.

63. The Rule is quite ambiguous on this point, as the term “other material consideration” is used as a category of consideration apart from “revenue,” but the specific disclosure of aggregate dollar amounts is limited to “revenue.”
Many of these benefits may not have an obvious market value, and the methods used to determine a value may vary from franchisor to franchisor. For example, it is consistent with good-faith accounting practices to treat discounts or rebates as a reduction in the cost of goods rather than recording them as revenue, meaning it might not be possible to isolate or report the amounts received. Counsel must work closely with accounting and finance teams to ensure that the required reporting is accurate and that necessary valuations are provided.

Discounts and rebates pose an additional challenge depending on the basis for payment. Although the Rule assumes that the franchisor or its affiliate or designee is selling most goods and services to the franchisee, in a modern supply chain the franchisor is often one among many resellers (even if the supply chain is limited to a small number of suppliers) that must compete for franchisee business. Under these circumstances, the franchisor may make purchases solely to meet its needs as a reseller and receive discounts or rebates from suppliers or manufacturers not by virtue of the access provided to the franchise system or the act of re-selling to the franchisees, but due to its own status as a customer in a competitive marketplace.

The Guide makes clear that “franchisors need not report ordinary sales or volume discounts that are offered by the supplier to all buyers, including the franchisees.” Unfortunately, the Guide does not say when or how to distinguish between a benefit received from ordinary sales and those that are “a result of franchisee purchases.” It may be advisable to apply a “but-for” causation analysis, whereby if the franchisor is only making the purchase because it intends to resell the products to the franchisees, then any purchase (and any related discount or rebate) is the “result” of a franchisee purchase. We do not agree that this is always the correct approach—while a franchisor may be acting as a reseller solely for the franchise system, this does not make every purchase decision by the franchisor the “result” of some future anticipated franchisee action. A franchisor using a capable supply management team will be making purchases for a slew of reasons that have nothing to do with the future sales to franchisees, even if the franchisor sells

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64. Generally, the question of whether some consideration is based on a purchase by the franchisee will only apply to non-cash payments from suppliers to the franchisor. Cash payments for goods and services from franchisees are plainly revenue, as discussed, and to the extent that a discount or rebate is based on the pass-through sale of goods to the franchisees, the relationship to a franchisee transaction is not in doubt. The offer of discounts or other benefits to franchisor purchases for the benefit of corporate-owned locations are also plainly subject to disclosure, although, as noted, it is not obvious that such benefits must be valued and included in revenue.

65. For example, a franchisor might purchase in excess of quarterly forecasted sales for a non-perishable product that is suddenly available at a great price in the general marketplace.

66. Putting aside the need to identify, categorically, whether a discount is or is not subject to disclosure, there is the practical problem that a franchisor is unlikely to be accounting for such transactions according to these artificial types—while a franchisor can probably determine the dollar amount of discounts on inventory purchases, breaking that amount down into the share applicable to “market” purchases that do not need to be disclosed and “based on franchisee action” purchases that do need to be disclosed is almost certain to be practically impossible.
only to franchisees and every item of inventory is intended for some franchisee to later buy.67

Once the appropriate pool of revenue is determined, the actual disclosure is quite straightforward. The franchisor must disclose its total revenue, taken from the franchisor’s audited financial statements,68 the amount of revenue from required purchases, the percentage of total revenue represented by the revenue from required purchases, and the revenue received by the franchisor’s affiliates.69

After disclosing total revenues, the franchisor must make a separate disclosure of the “basis for payment” from the designated supplier(s)70 “to the franchisor from franchisee purchases.”71 The payments must be disclosed either as a range of percentages, or as a range of dollar amounts, and all payments from all suppliers may be aggregated in the disclosure. For example, if the franchisor receives a payment from three different suppliers, equal to one percent, three percent, and six percent of the value of the franchisee purchases, then the disclosure would state that the franchisor may receive payments of between one and six percent of the value of franchisee purchases. Alternatively, if the payment is better expressed in dollars (say, $1,000, $3,000, and $6,000) then the disclosure would state that the franchisor may receive payments of between $1,000 and $6,000. The franchisor can choose the format of the disclosure. The identity of the suppliers and the specific amounts attributable to each supplier need not be disclosed.72

7. Purchasing Cooperatives

Franchisors must disclose the existence of purchasing cooperatives, unless the franchisee is required to participate, in which case the “identity” of the

67. Inventory management practices now move at the speed of the Internet, and prices and purchase incentives (discounts and credits) can change from hour-to-hour, something that was definitely not true in the world of faxed purchase orders and carbon-copy packing slips that gave birth to the Rule and the UFOC Guidance on which the current Item 8 is based. For example, a savvy inventory manager might agree to purchase soon-to-be-obsolete stock from a supplier at a steep discount, not based on forecasted sales but because the discount will raise margin on sales sufficient to offset the likely need to dispose of some amount of product and take a future write-down. Alternatively, the franchisor might make such a purchase as a favor to a supplier, in exchange for future return credits or rebates or discounts or even just a friendly working relationship—again, where such actions are not at all motivated by expected sales to franchisees. This is all to say nothing of purchases from online marketplaces, where the volume and price points are pre-determined by algorithms—essentially computers buying from computers without the benefit of a direct human motive. This is a potentially serious issue with the “result” framework which requires some understanding of the intention of the buyer/seller with regard to the benefit at issue to determine if there is an event subject to disclosure.

68. If the franchisor does not have audited financial statements, then the sources of information used to calculate the revenue must also be disclosed. 16 C.F.R. § 436.5(h)(6)(i) n.5.

69. Id. § 436.5(h)(6)(i)-(iv). The sources of information used to calculate affiliate revenue must also be disclosed. Id. § 436.5(h)(6)(i), n.5.

70. A supplier is intended to “capture all third parties in the manufacturing and distribution chain who may make payments to the franchisor or any of its affiliates when their goods are sold to franchisees.” Guide, supra note 19, at 53.

71. 16 C.F.R. § 436.5(h)(8).

cooperative must also be disclosed.  The Rule and the Guide provide no direction on what must be included in this disclosure. It may be a reflection of an increase in the use of cooperatives between 2007 and 2019, but little to nothing is said about cooperatives in the Statement of Basis and Purpose or the Staff Report, and no specific details are provided about the process cooperatives use to select and approve suppliers or the rights of franchisees to participate in those processes. It may be that future revisions to the Rule will enhance the disclosures related to these increasingly critical parts of the supply chain.

8. Miscellaneous Franchisor Activities

Finally, the franchisor must disclose if it “provides material benefits” to franchisees based on the “purchase of particular products or services or use of particular suppliers.” Such benefits may include rights of renewal or the opportunity to purchase additional franchises. Franchisors must also disclose if they negotiate purchase agreements with suppliers on behalf of the system, including pricing, but the specific price terms need not be disclosed.

III. Additional Concerns

Disclosure is not the only risk that counsel advising their business partners must consider. A franchisor may bear responsibility for the conduct of its suppliers, and it may also face liability from franchisees or from the public arising therefrom.

A. Quality Control

Franchisors must ensure that their supply chains provide quality goods and services; even with disclosure of the relationships, franchisees may have a claim for breach of the franchise agreement if the franchisor’s products are not of good quality. For example, in Ponderosa Systems, Inc. v. Brandt, the franchisee, as defendant, won a jury verdict on its counterclaims for breach of implied warranties, breach of duty of good faith and fair dealing, and fraud. The Tenth Circuit held that the district court did not abuse its discretion when admitting evidence asserted to be prejudicial to the franchisor, including evidence that the franchisor received several complaints related to the quality of the meat purchased from the franchisor’s approved supplier; specifically, that it was “poor quality, poor consistency, odorous, spoiled, rotten and rodent damaged.” The evidence of poor quality products was vital

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73. This is another example of an extra-textual regulatory requirement “imposed” by the interpretive guidance. Guide, supra note 19, at 55.
74. 16 C.F.R. § 436.5(h)(11).
75. Id.
76. Id. § 436.5(h)(10); Guide, supra note 19, at 55.
to the defendants in proving that the franchisor damaged their business and failed in its obligations as a franchisor. It is imperative for franchisor counsel to work with supply chain business leaders to ensure that quality controls are in place and that the goods meet minimal standards of merchantability.

B. Customer Injury

Franchisors have also been subject to liability from claims asserted by their franchisee’s customers arising from the use of required products and services. In *Plunkett v. Crossroads of Lynchburg, Inc.*, a negligence claim was brought against the franchisee and franchisor, Mercedes-Benz, after a customer suffered a slip-and-fall injury. The complaint alleged that the franchisor mandated a floor finish which made it difficult to detect when liquid substances were on the floor, also making it extremely slippery, which resulted in the customer’s injury. In several other cases, the courts have recognized potential liability that a franchisor may have for an injury on the franchisee’s premises when the franchisor controlled the particular instrumentality or design feature that caused the injury. As with product quality, the decision to control sourcing or mandate products can expose the franchisor to the risks of consumer and franchisee injuries that result from the use of those controlled products and services. Franchisor counsel should be aware of potential product liability claims and work with supply chain management to ensure that risks and dangers are considered when choosing suppliers or mandating products or services.

C. Price Discrimination

Periodically, a franchisee will bring an action claiming that a restricted supply chain arrangement, especially one that includes rebates or payments from the designated supplier to the franchisor, is actually illegal price discrimination under Section 2 of the Robinson-Patman Act. The claims, which typically fall under the secondary category of competitive injury outlined by the Supreme Court, commonly assert that the franchisor is harming the franchisees by forcing them to buy products at a price that is higher than what is available to other purchasers not subject to the franchisor’s control. The franchisee usually alleges that the franchisor has agreed to deliver a captive group of buyers to the supplier at an unfair price in exchange for a rebate or other payment.

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80. *Id.*


82. *Id.*


84. The Supreme Court has identified three categories of injury under Section 2: primary, which runs against a direct competitor of the seller, secondary, which harms competition among the seller’s customers, and tertiary, which harms the end user (the buyer’s customers). Volvo Trucks N. Am. Inc. v Reeder-Simco GMC, Inc., 546 U.S. 164, 176 (2006).
Although this type of claim may present a serious supply chain risk for franchisors, it has proven extremely difficult for franchisees to prevail. To establish unlawful price discrimination, the franchisee must plead, and then prove at trial, that as a result of the discriminatory pricing the franchisee has lost sales to a favored purchaser. If there is no evidence of direct competition with a comparable business receiving the favorable pricing, then the claim will not succeed. Thus, in *Benfeldt v. Window World, Inc.*, the franchisees that claimed harm from the system's restrictive supply arrangement needed to show that they were directly losing sales to a non-franchisee who was buying products from the same supplier under more favorable terms. The mere possibility of receiving more favorable pricing outside the franchisee's restricted supplier arrangement was probably insufficient to state a claim, and the fact that the franchisor may receive an inducement to offer exclusivity, even at allegedly unfair prices, was also likely insufficient to state a claim.

D. Tying

A second claim that is periodically raised by franchisees is unlawful tying, whereby the franchisor is alleged to have violated Section 1 of the Sherman Act by conditioning the sale of franchises to the sale of unrelated products (such as those the franchisee is required to buy from the franchisor or its suppliers). This claim has proved even more difficult than the price discrimination claim under the Robinson-Patman Act. The Third Circuit in 1997 rejected a tying claim brought against Domino's Pizza arising out of the mandatory purchase of ingredients from a Domino’s affiliate. The court rejected the allegation that Domino's restricted sourcing created a “market” exclusive to Domino’s franchisees. The Court based its decision in part on the fact that the Domino’s franchisees were aware, prior to entering into the franchise agreement, that Domino’s could exert control over their

85. Id. at 177.
87. Id. at *3. The district court dismissed the Robinson-Patman claim, despite a paragraph in the complaint alleging that “Plaintiffs competed against other window sales and installation businesses who purchased the same AMI windows, but on superior terms and without AMI’s markup that was imposed exclusively on sales of windows to WW licensees/franchisees,” because the plaintiffs failed to specifically “identify any disfavored Bendfeldt retailer, any favored AMI customer, any ‘market area’ where competition took place, or the amount or duration of any supposed discrimination.” Id.
88. Note that the franchisee must begin by alleging that it is receiving unfavorable or uncompetitive pricing. If the franchisor focuses its supplier arrangements on offering competitive or even favorable pricing, this claim should not be an issue.
89. *Queen City Pizza, Inc. v. Domino’s Pizza, Inc.*, 124 F.3d 430 (3d Cir. 1997).
90. “Were we to adopt plaintiff's position that contractual restraints render otherwise identical products non-interchangeable for purposes of relevant market definition, any exclusive dealing arrangement, output or requirement contract, or franchise tying agreement would support a claim for violation of antitrust laws. Perhaps for this reason, no court has defined a relevant product market with reference to the particular contractual restraints of the plaintiff.” Id. at 438.
purchasing and elected to contract with Domino’s despite that knowledge.91 The Queen City decision, which has been favorably viewed in other circuits,92 has the effect of offering protection from tying claims to those franchisors who properly disclose their purchasing requirements in Item 8.

E. Fraud

A key factor in Queen City was the franchisee’s awareness of Domino’s power to control purchasing when it entered into the franchise agreement. It remains an open question whether a court might distinguish Queen City if the franchisor hid or misled a prospective franchisee about supply chain restrictions. Of course, the franchisor also risks demands for rescission or other claims for damages if there is any material omission in the FDD or failure to disclose or other alleged fraud. The simplest and most ethical remedy for this, which we whole-heartedly recommend, is to ensure that the FDD is accurate and that all material information regarding the supply chain and the franchisor’s relationships is disclosed and that steps are taken to keep franchisees involved with and informed about critical supply chain decisions. And it does not hurt to secure competitive pricing for restricted source goods, if possible—as a general rule, franchisees do not bring claims if they are profitable.

Conclusion

Item 8 is not, to be frank, a “sexy” provision in the FDD. It covers matters of complexity and obscurity that are not always fully understood by counsel. Yet, counsel has an important role to play in advising both franchisors and franchisees in selecting suppliers, structuring payments, approving rebates and discounts, and deciding how much control a franchisor (or purchasing cooperative) wants or needs over the supply chain. We recommend that counsel work closely with both supply chain managers and finance managers to understand how products and services move through the franchise system and how those products and services are paid for and valued. Only by developing a thoughtful analytical framework for understanding and advising on the disclosures required by Item 8 can counsel fully protect the franchisor from supply chain risks such as franchise disclosure violation, antitrust and fraud claims, poor quality controls, and non-competitive pricing for goods and services.

91. “[T]he Domino’s franchisees could assess the potential costs and economic risks at the time they signed the franchise agreement.” Id. at 440.
The State of Washington’s Attempt to Ban Franchise Anti-Poaching Provisions Nationwide Violates Constitutional Limitations on State Power to Regulate National Commerce

Michael L. Sturm

“No poach” or “anti-poaching” clauses in franchise agreements are provisions that restrict franchisees from hiring employees of their franchisor or of other franchisees in the same system. Franchisors have included these provisions in their franchise agreements for many years; courts historically upheld them as legitimate efforts to promote a franchise system’s unity and interbrand competitive strength.¹ Recently, however, critics of such provisions have argued that they might suppress employees’ wages and mobility.²

In a press release issued earlier this year, Washington Attorney General Robert W. Ferguson announced that he had moved “closer to his goal of eliminating no-poach clauses” from franchise agreements “nationwide.”³ Attorney General Ferguson has pursued this goal by threatening to sue national franchisors under Washington State antitrust law if they do not agree to remove anti-poaching provisions from their franchise agreements nationwide. One

¹. See, e.g., Williams v. Nevada, 794 F. Supp. 1026, 1031 (D. Nev. 1992) (rejecting antitrust challenge to anti-poaching provision as a matter of law and noting that “the franchisor does everything to promote a uniform, non-competitive environment between the franchisees”), aff’d sub nom. Williams v. L.B. Fischer Nevada, 999 F.2d 445 (9th Cir. 1993).

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such suit was filed in 2018 and settled in August 2019.⁴ Economists disagree as to whether anti-poaching provisions in franchise agreements promote or restrain growth in labor markets; this debate undoubtedly will continue.⁵ But Attorney General Ferguson’s campaign raises a structural question that goes to the heart of constitutional federalism: should an elected official in Olympia, Washington, or any other state capital, be regulating the terms of franchise agreements nationwide?

This question transcends the current debate over franchise anti-poaching provisions. As activist state governments regulate more aggressively in response to perceived political imperatives and federal retrenchment, extra-territorial assertions of state power are likely to proliferate. Regardless of salutary motives, the United States Constitution and controlling decisions of the Supreme Court clearly forbid such an arrogation of power by state governments. Acceptance of the premise underlying the Washington anti-poaching initiative would upend the constitutional balance not only between the states and the federal government, but also among the states as co-equal sovereigns.

The framers of the Constitution feared state interference with national commerce. As stated by Alexander Hamilton in *The Federalist Papers*, absent federal authority to displace conflicting state laws, “[e]ach State, or separate confederacy, [c]ould pursue a system of commercial polity peculiar to itself. This would occasion distinctions, preferences, and exclusions, which would beget discontent.”⁶ Thus, the Commerce Clause entrusts Congress with the power “[t]o regulate Commerce with foreign Nations and among the several States.”⁷ While this language by its terms merely confers federal legislative power, the Supreme Court has long held that it also entails an implicit “dormant” component that limits attempts by state governments to regulate in ways that might impede the flow of interstate commerce, whether or not Congress has acted in the area.⁸ Together, the affirmative and dormant


⁶. The Federalist No. 7 (Alexander Hamilton).

⁷. U.S. Const. art. I, § 8, cl. 3.

⁸. The “dormant” nomenclature originated with Chief Justice Marshall’s opinion in *Gibbons v. Ogden*, 22 U.S. 1 (1824), and refers to situations in which Congress has not exercised its affirmative regulatory authority (thus, the textually authorized power lay “dormant”). At least initially, there were questions as to whether the Commerce Clause permitted any concurrent state authority over interstate commerce. It has become clear, however, that states have concurrent authority subject to the limits imposed by any affirmative federal regulation and the dormant Commerce Clause. See Cooley v. Bd. of Wardens, 53 U.S. 299 (1851).
aspects of the Commerce Clause protect a unified national economy. As explained by Justice Cardozo, the Constitution was “framed upon the theory that the peoples of the several states must sink or swim together, and that in the long run prosperity and salvation are in union and not division.”

Over the course of more than a century, the Supreme Court has established that the dormant Commerce Clause not only prohibits protectionism and discrimination against out-of-state economic interests, but also prohibits state regulation of out-of-state economic transactions. The state of Washington’s express attempt to banish anti-poaching provisions from franchise agreements nationwide cannot be reconciled with this latter principle. Attorney General Ferguson is openly seeking to regulate the terms of franchise agreements that have no substantial relationship to Washington (e.g., preventing a New York franchisor from entering into an agreement containing an anti-poaching provision with a Florida-based prospective franchisee). Because of this direct interference with, and regulation of, out-of-state transactions, claims as to possible collateral effects on Washington’s labor market, even if credited, could not justify this intrusion. Even under the least demanding balancing test that could be applied, the direct control over out-of-state contracts and commerce would far outweigh any claimed in-state benefits. Moreover, any perceived national benefits are irrelevant to the analysis; the state of Washington has “no legitimate interest” in protecting non-residents. Under the Constitution, decisions concerning the national economy must be made by the federal government in accordance with its affirmative power under the Commerce Clause, not by one or more states or state officials.

The Constitution protects “the autonomy of the individual States within their respective spheres”; this autonomy would be diminished if states could seize regulatory authority beyond “their respective spheres.” Moreover, while a significant number of states in addition to Washington have sought to prohibit franchise anti-poaching provisions, a substantial majority have not. The regulatory (or non-regulatory) choices of the latter states are entitled to respect as co-equal sovereigns. Finally, while he was elected by Washington voters, Attorney General Ferguson is not politically accountable to the national populace that he seeks to regulate under his anti-poaching initiative. The absence of political constraints provides a further basis for confining the effect of his policy choices to the citizens to whom he is accountable.

This article explains why the attempt by the attorney general of Washington to eliminate franchise anti-poaching provisions “nationwide” is forbidden by the United States Constitution through its dormant Commerce Clause. The article first describes the anti-poaching initiatives undertaken by Attorney General Ferguson and other state attorneys general. Next, the article reviews the constitutional structure and key Supreme Court decisions under the dormant Commerce Clause that limit extraterritorial regulatory authority. The article also considers recent federal circuit court decisions that address other attempts by states to engage in extraterritorial regulation. The article concludes by discussing the reasons why the state government in Olympia may not act as a national regulator of franchise agreements, whether it claims to be acting in the national public interest, or is relying solely on purported tangential effects in Washington. Because Washington is attempting to impose its public policy views on purely out-of-state transactions, it is usurping the role of the federal government and interfering with the sovereignty of its sister states in violation of the dormant Commerce Clause.

I. The Initiatives Against Franchise Anti-Poaching Provisions

Washington Attorney General Ferguson began investigating anti-poaching provisions in franchise agreements in January 2018. According to press releases, his office subsequently has reached agreements with dozens of franchisors to eliminate such provisions nationwide. When franchisor Jersey Mike’s declined to amend its existing franchise agreements to the attorney general’s satisfaction, even though it agreed to cease inclusion of those provisions going forward, Jersey Mike’s was sued for alleged violations of Washington’s antitrust law. While the complaint identified the New Jersey-based franchisor and several of its Washington-based franchisees as named defendants, the complaint also asserted that those named defendants conspired with “all Franchisees in the United States . . . who signed a No-Poach Provision” to violate the Washington statute. And press releases leave no room for doubt

17. See Order Denying Jersey Mike’s Franchise Sys., Inc.’s Mot. to Dismiss (King Cty. Super. Ct. Jan. 25, 2019). The motion did not raise the extraterritorial enforcement issues discussed in this article, and the court did not address them.
that the case against Jersey Mike’s is part of an integrated effort to eliminate anti-poaching provisions in franchise agreements nationwide.\textsuperscript{19}

Attorney General Ferguson is not the only state official who has recently attacked anti-poaching provisions in franchise agreements. A group of fourteen other state attorneys general has announced anti-poaching settlements with a significant number of national franchisors.\textsuperscript{20} In addition, on July 15, 2019, a group of seventeen state attorneys general, joined by the attorney general of the District of Columbia, filed comments with the Federal Trade Commission addressing labor-related issues, including anti-poaching provisions in franchise agreements.\textsuperscript{21} Among other positions, these attorneys general stated that they “have generally viewed [franchise anti-poaching] agreements as subject to per se review, or alternatively, argue that they should be analyzed using a ‘quick look’ rule of reason standard” under the antitrust laws.\textsuperscript{22}

Yet the fact that only seventeen state attorneys general joined in these Comments necessarily means that the attorneys general of approximately two-thirds of the states did not. And the United States Department of Justice Antitrust Division, which is charged with enforcing the federal antitrust laws nationwide, has made clear in recent Statements of Interest and other public pronouncements that it disagrees with this minority of state attorneys general and believes that, because of potential pro-competitive effects, anti-poaching provisions in franchise agreements should be evaluated under the full rule-of-reason standard rather than either being deemed per se illegal or considered under the quick-look doctrine.\textsuperscript{23} Likewise, while federal legislation banning anti-poaching provisions in franchise agreements was introduced in Congress, it was not voted upon in either house, let alone enacted into law.\textsuperscript{24} Thus, Attorney General Ferguson’s initiative seeking to eliminate anti-poaching agreements from franchise agreements nationwide can be seen only as an attempt to enforce the state of Washington’s policies throughout the country, notwithstanding the lack of any clear national consensus. The question of the limits of state power is thus squarely presented.

\begin{itemize}
\item \textsuperscript{19} Press Release, \textit{supra} note 16.
\item \textsuperscript{22} Id. at 5.
\item \textsuperscript{24} See End Employer Collusion Act, H.R. 5632, 115th Cong. (2018); S. 2480, 115th Cong. (2018).
\end{itemize}
II. Constitutional Allocation of Power

A. Background of Constitutional Federalism

The principles that define the relationship between the federal and state governments, as well as between the states vis-à-vis one another, were established in the Constitution and remain fundamentally unaltered. At the most basic level, the federal government has limited but supreme power. It may act only within the scope of its enumerated powers; when it does so, however, its actions control over any contrary state action.\(^{25}\) In contrast, state governments in theory have plenary authority, generally referred to as “police power.”\(^{26}\) The exercise of state sovereign power is constrained only to the extent ceded to the federal government by adoption of the U.S. Constitution, preempted by federal law, or forbidden by the U.S. Constitution or the state’s own constitution.

An important, although unstated, limitation on state sovereign authority is that it applies only within the boundaries of the state. As the U.S. Supreme Court has noted, “all States enjoy equal sovereignty.”\(^{27}\) Allowing one state to project its power into a sister state necessarily impinges upon the sovereignty of the latter to govern the affairs of its own citizens. The Brandeisian notion of states as laboratories of democracy would cease to function if states could effectively preempt the laws of other states, as federal law preempts conflicting state law under the Supremacy Clause.\(^{28}\) Such external projections of state power would also create the near certainty of conflicting regulatory imperatives. At the same time, however, in a national economy, innumerable transactions will permeate state boundaries, and business entities necessarily will be regulated by multiple states. Thus, absent some bright-line prohibition of state regulation of matters touching on interstate commerce, which would leave an impractical void and, in any event, was rejected more than a century ago,\(^{29}\) the boundaries of concurrent state authority must be defined.\(^{30}\)

\(^{25}\) See U.S. Const. art. VI, cl. 2 (“This Constitution and the Laws of the United States which shall be made in Pursuance thereof . . . shall be the Supreme law of the Land; and the Judges in every State shall be bound thereby, any Thing in the Constitution or laws of any State to the Contrary notwithstanding”); id. amend. X (“The powers not delegated to the United States by the Constitution, nor prohibited to it by the States, are reserved to the States respectively, or to the people.”); see also Alden v. Maine, 527 U.S. 706, 713 (1999) (“The limited and enumerated powers granted to the Legislative, Executive, and Judicial Branches of the National Government . . . underscore the vital role reserved to the States by the constitutional design.”).


\(^{28}\) New State Ice Co. v. Liebmann, 285 U.S. 262, 311 (1932) (Brandeis, J., dissenting).


\(^{30}\) There are numerous issues, many of which are quite complex, that relate to the subject of state power but are beyond the scope of this article. These include, by way of example only, full faith and credit, choice of law, state court jurisdiction, and nexus for taxing purposes.
B. The Punitive Damages Decisions

Despite the importance of the issue in its structural scheme, the Constitution itself provides relatively little guidance regarding the limits of state power. Surprisingly, two Supreme Court decisions concerning punitive damages are among the most helpful in illuminating these limits. In *BMW of North America, Inc. v. Gore*, the Court considered an award of punitive damages by an Alabama jury that was premised upon BMW’s national policy against disclosure of pre-sale repairs of new cars (in this case, hood repainting). This nondisclosure policy violated Alabama law, but not the laws of at least twenty-five other states. Nevertheless, the jury heard evidence that BMW had sold approximately 1,000 repainted “new” cars nationwide, and Dr. Gore’s counsel argued that the jury should award $4 million in punitive damages based upon $4,000 in diminished value per car for each of those cars. The jury apparently accepted this argument and awarded the requested $4 million in punitive damages, even though only fourteen of the repainted cars were actually sold in Alabama.

In reversing the award of punitive damages, the Supreme Court made important observations regarding the differences between state and federal regulatory authority and the limits of state power. With respect to disclosure requirements, the Court noted that

> [n]o one doubts that a State may protect its citizens by . . . requiring automobile distributors to disclose presale repairs that affect the value of a new car. But the States need not, and in fact do not, provide such protection in a uniform manner. . . . The result [of the differences] is a patchwork of rules representing the diverse policy judgments of lawmakers in 50 States.

The Court further explained that, to the extent that any effort at unification was to be undertaken, it would be the responsibility of Congress: “[W]hile we do not doubt that Congress has ample authority to enact [a uniform disclosure] policy for the entire Nation, it is clear that no single State could do so, or even impose its policy choice on neighboring States.” Stated otherwise, “[O]ne State’s power to impose burdens on the interstate market for automobiles is not only subordinate to the federal power over interstate commerce, but is also constrained by the need to respect the interests of other States.” For the latter proposition, the Court cited its dormant Commerce Clause jurisprudence discussed in more detail below. And, in words that are equally applicable to the Washington anti-poaching initiative, the

32. *Id.* at 565.
33. *Id.* at 564.
34. *Id.* at 564–65.
35. Prior to the U.S. Supreme Court’s consideration of the case, the Alabama Supreme Court had reduced the $4 million award of punitive damages to $2 million. *Id.* at 567. Nevertheless, the U.S. Supreme Court found even the reduced award excessive, as discussed in the text.
36. *Id.* at 568–70 (citations omitted).
37. *Id.* at 571 (citations omitted).
38. *Id.* (citations omitted).
Court summarized that “it follows from these principles of state sovereignty and comity that a State may not impose economic sanctions on violators of its laws with the intent of changing . . . lawful conduct in other States.”

In *State Farm Mutual Insurance Co. v. Campbell*, the Supreme Court reiterated these principles of federalism. Like *BMW v. Gore*, *Campbell* involved a punitive damages award (in this case, $145 million) premised on alleged nationwide misconduct. Again, the Supreme Court reversed the judgment, concluding under the Fourteenth Amendment Due Process Clause that the state of Utah, acting through its courts, lacked authority to punish conduct that was lawful elsewhere. In so holding, the Court cited its precedents dating back over a hundred years, which establish that “[a] basic principle of federalism is that each State may make its own reasoned judgment about what conduct is permitted or proscribed within its borders.” The Court also cited its 1914 decision in *N.Y. Life Insurance Co. v. Head* concluding that the federalism-based territorial limit on state authority “is so obviously the necessary result of the Constitution that it has rarely been called into question and hence authorities directly dealing with it do not abound.”

### C. Reaffirmation of the Dormant Commerce Clause

While it remains true that “authorities . . . do not abound,” it is now clear that the dormant Commerce Clause provides the appropriate legal framework for assessing the constitutionality of state assertions of extraterritorial authority over matters involving commerce. As noted above, the text of the Commerce Clause provides only an affirmative grant of power; it does not expressly constrain state power on grounds of federalism or otherwise. At least two recent Supreme Court justices, and some commentators, have called for the limitation or repudiation of dormant Commerce Clause jurisprudence, arguing in substance that a mere negative implication from an affirmative grant of power is too thin a reed upon which to base a significant body of law and, in particular, to invalidate otherwise lawful state actions.

Earlier this year, however, the Ninth Circuit rejected a renewed challenge to California’s Low Carbon Fuel Standard purportedly based on “the federal structure of the Constitution,” rather than the dormant Commerce Clause.

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39. *Id.* at 572.
41. *Id.* at 420 (“From their opening statements onward, the Campbells framed this case as a chance to rebuke State Farm for its nationwide activities.”).
42. *Id.* at 422.
43. *Id.* at 421 (quoting *N.Y. Life Ins. Co. v. Head*, 234 U.S. 149, 161 (1914)).
44. *U.S. Const. art. I, § 8, cl. 3.*
45. See *General Motors Corp. v. Tracy*, 519 U.S. 278, 312 (1997) (Scalia, J., concurring) (opining that “the so-called 'negative' commerce clause is an unjustified judicial invention, not to be expanded beyond its existing domain”); *United Haulers Ass'n, Inc. v. Oneida-Herkimer Solid Waste Mgmt. Auth.*, 550 U.S. 330, 349 (2007) (Thomas, J., concurring) (expressing that “[t]he negative Commerce Clause has no basis in the Constitution and has proved unworkable in practice”).
framework that the court had previously considered. The court reasoned that “[t]here is simply no reason to search beyond the Commerce Clause for the Constitution’s limits on the ability of states to affect interstate commerce.”

Similarly, at the end of its 2018–2019 term, the Supreme Court itself by a 7-2 vote reiterated the continuing vitality of its dormant Commerce Clause jurisprudence, noting pragmatically that, in light of the Framers’ demonstrated concerns about creating an integrated national economy, “it would be strange if the Constitution contained no provision curbing state protectionism, and at this point in the Court’s history, no provision other than the Commerce Clause could easily do the job.” In light of this reaffirmation, it is appropriate to consider whether Attorney General Ferguson’s initiative passes muster under the Court’s dormant Commerce Clause precedents.

III. The Supreme Court’s Dormant Commerce Clause Jurisprudence

While the dormant Commerce Clause most frequently has been invoked against attempts to discriminate against out-of-state economic interests, economic favoritism is not the sole target of the Supreme Court’s jurisprudence in this area. Rather, to the extent that a state purports to interfere directly with commercial transactions in another state, that regulation is impermissible as well. Thus, in Edgar v. MITE Corp., the Supreme Court invalidated an Illinois anti-takeover statute, holding that “[t]he Commerce Clause . . . precludes the application of a state statute to commerce that takes place wholly outside of [a] State’s borders, whether or not the commerce has effects within the State.” Relying on its 1970 decision in Pike v. Bruce Church, Inc., the Court noted:

Not every exercise of state power with some impact on interstate commerce is invalid. A state statute must be upheld 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.”

The Court made clear, however, that “[t]he Commerce Clause permits only incidental regulation of interstate commerce by the states; direct regulation is prohibited.”

47. Rocky Mountain Farmers Union v. Corey, 913 F.3d 940, 953–54 (9th Cir. 2019).
48. Id. at 954.
52. Id. at 640 (quoting Pike v. Bruce Church, Inc., 397 U.S. 137, 142 (1970)). This is often referred to as the Pike v. Bruce Church balancing test.
53. Id.
The Illinois Business Takeover Act at issue in *Edgar v. MITE Corp.* failed both tests. The Court noted that the statute “could be applied to regulate a tender offer which would not affect a single Illinois shareholder” and that it was “therefore apparent that the Illinois statute [was] a direct restraint on interstate commerce” that had “a sweeping extraterritorial effect.”54 In addition to being a prohibited “direct restraint,” the Illinois statute was also invalid because its burden on interstate commerce far exceeded its putative local benefit. With respect to the burden, the Court noted the statute’s “nationwide reach.”55 And while the state had a legitimate interest in protecting resident shareholders, the Court explained that “the State has no legitimate interest in protecting nonresident shareholders,” thereby rejecting any notion that states have some roving authority to promote perceived public interest outside their borders.56 Thus, in addition to constituting a prohibited direct regulation, the Illinois statute also failed the *Pike v. Bruce Church* balancing test.

Four years after *Edgar v. MITE Corp.*, the Supreme Court struck down a New York “affirmation” statute that required liquor producers whose products were sold in New York to certify that they did not charge higher prices to wholesalers in New York than elsewhere.57 In the absence of such a certification, the New York Liquor Authority could revoke the producer’s authority to sell in New York. However, executing the certification was problematic for the producers in part because of certain advertising allowances that were permitted in other states but prohibited in New York.

On the one hand, in summarizing its prior precedents, the Court in *Brown-Forman* stated that “[w]hen a state statute directly regulates or discriminates against interstate commerce . . ., we have generally struck down the statute without further inquiry.”58 On the other hand, when “a statute has only indirect effects on interstate commerce and regulates evenhandedly, [the Court has] examined whether a State’s interest is legitimate and whether the burden on interstate commerce clearly exceeds the local benefits.”59 The Court cautioned, however, that “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. In either situation the critical consideration is the overall effect of the statute on both local and interstate activity.”60

*Brown-Forman* clarified two important points in the dormant Commerce Clause analysis. First, even though the New York statute and its potential associated administrative penalty by their terms only directly pertained to sales in New York, the Court found that the “practical effect” of the law was

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54. Id. at 642.
55. Id. at 643.
56. Id. at 644.
58. Id. at 579.
59. Id. (citing *Pike v. Bruce Church, Inc.*, 397 U.S. 137 (1970)).
60. Id.
to control prices in other jurisdictions. This sufficed to establish a Commerce Clause violation. Second, the Court stated that “forcing a merchant to seek regulatory approval in one State before undertaking a transaction in another directly regulates interstate” commerce and would therefore amount to a per se violation of the dormant Commerce Clause.

Three years later, in *Healy v. Beer Institute, Inc.*, the Court summarized its dormant Commerce Clause jurisprudence as establishing three principles:

First, the “Commerce Clause” . . . precludes the application of a state statute to commerce that takes place wholly outside the State’s borders, whether or not the commerce has effects within the State. . . . Second, a statute that directly controls commerce occurring wholly outside the boundaries of a State exceeds the inherent limits of the enacting State’s authority and is invalid regardless of whether the statute’s extraterritorial reach was intended by the legislature. The critical inquiry is whether the practical effect of the regulation is to control conduct beyond the boundaries of the State. . . . Third, the practical effect of the statute must be evaluated not only by considering the consequences of the statute itself, but also considering how the challenged statute may interact with the legitimate regulatory regimes of other States . . . . And, specifically, the Commerce Clause dictates that no State may force an out-of-state merchant to seek regulatory approval in one State before undertaking a transaction in another.

Applying these principles, the Court invalidated a Connecticut price-affirmation statute that had the “undeniable effect of controlling commercial activity occurring wholly outside the boundary of the State.” *Pike v. Bruce Church, Edgar v. MITE Corp., Brown-Forman,* and *Healy v. Beer Institute* remain the leading authorities delineating the boundaries of the dormant Commerce Clause limitation on states’ attempts to regulate beyond their borders.

**IV. State Attempts to Extend Their Regulatory Authority Beyond Their Borders**

Attempts by state governments to regulate beyond their boundaries have proliferated in recent years; federal courts of appeals have struck down many of these attempts based on dormant Commerce Clause principles. While a comprehensive survey of these decisions is beyond the scope of this article, a

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61. *Id.* at 583.
62. *Id.* at 582.
64. *Id.* at 336–37 (citations omitted).
65. *Id.* at 337.
66. In *Pharmacy Research & Manufacturers of America v. Walsh*, the Court affirmed rejection of a dormant Commerce Clause challenge to a pharmaceutical pricing program because it agreed with the court of appeals that “the Maine Act does not regulate the price of any out-of-state transaction, either by its express terms or by its inevitable effect.” 538 U.S. 644, 669 (2003) (quoting Pharm. Research & Mfrs. of Am. v. Concannon, 249 F.3d 66, 81–82 (1st Cir. 2001)). The Court’s recent decision in *Tenn. Wine & Spirits Retailers Ass’n v. Thomas*, as discussed earlier, focused on the anti-protectionism application of the dormant Commerce Clause, not extraterritorial effects.
review of several recent decisions provides context for the subsequent analysis of the Washington anti-poaching campaign.67

In 2017, in *Legato Vapors, LLC v. Cook*, the Seventh Circuit considered an Indiana law that regulated out-of-state manufacturing processes for “vaping” fluids sold in Indiana, including detailed security and audit requirements and the requirement of a permit from an Indiana administrative agency.68 Although the law on its face was non-discriminatory, the Seventh Circuit readily concluded that, “[a]s applied to out-of-state manufacturers, the security provisions of the Indiana Act violate the Commerce Clause [because] [t]hey operate as extraterritorial legislation, governing the services and commercial relationships between out-of-state manufacturers and their employees and contractors. With almost two hundred years of precedents to consider, our review of prior dormant Commerce Clause decisions has not revealed a single appellate case permitting any direct regulation of out-of-state manufacturing processes and facilities similar to the Indiana Act.”69

Similarly, in its 2018 decision in *Ass’n for Accessible Medicines v. Frosh*, the Fourth Circuit reversed the district court and invalidated a Maryland generic drug pricing law that prohibited “price gouging” by manufacturers and distributors on drugs that were “made available for sale” in Maryland.70 The statute’s reach was not limited to sales to consumers or other transactions that occurred in Maryland. Rather, the state admitted that it applied to sales between manufacturers and distributors that were “‘upstream’ sales [that] would occur almost exclusively outside Maryland.”71 Relying upon *Edgar v. MITE Corp.*, *Brown-Forman*, and *Healy v. Beer Institute*, the Fourth Circuit held that the statute violated the dormant Commerce Clause because it “effectively seeks to compel manufacturers and wholesalers to act in accordance with Maryland law outside Maryland. This it cannot do.”72 Further, “[a]ny legitimate effects the Act may have in Maryland are insufficient to protect the law from invalidation.”73

The Ninth Circuit also has been active in deciding extraterritoriality cases. In *Sam Francis Foundation v. Christies, Inc.*, the court sitting en banc invalidated a California resale royalty law that required payment of a royalty to an artist upon sale of a work of fine art whenever the sale occurred in California or the seller resided in California.74 While the law was not

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67. In 2010, the First Circuit suggested that “[e]xtraterritoriality has been the dormant branch of the dormant Commerce Clause.” IMS Health, Inc. v. Schneider, 616 F.3d 7, 29 n.27 (1st Cir. 2010), vacated on other grounds sub nom. IMS Health, Inc. v. Mills, 564 U.S. 1051 (2011). As the discussion in the text demonstrates, however, at a minimum the supposedly “dormant” doctrine has been revived in the latter portion of the decade.
68. Legato Vapors, LLC v. Cook, 847 F.3d 825 (7th Cir. 2017).
69. Id. at 830–31.
71. Id. at 671.
72. Id. at 672.
73. Id.
74. Sam Francis Found. v. Christies, Inc., 784 F.3d 1320 (9th Cir. 2015) (en banc).
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problematic insofar as it applied to in-state sales, the court relied on *Healy* to “easily conclude” that application to out-of-state sales violated the dormant Commerce Clause because “the Act directly regulates the conduct of the seller or the seller’s agent for a transaction that occurs wholly outside the State.” By way of example, the court noted that, if a seller happened to reside in California, but “has a part-time apartment in New York, buys a sculpture in New York from a North Dakota artist to furnish her apartment, and later sells the sculpture to a friend in New York, the Act requires the payment of a royalty to the North Dakota artist—even if the sculpture, the artist, and the buyer never traveled to, or had any connection with, California.” This scenario, the court concluded, could not survive scrutiny under the dormant Commerce Clause.

Last year, in *Daniels Sharpsmart, Inc. v. Smith*, the Ninth Circuit upheld a preliminary injunction enjoining California Department of Public Health officials from enforcing a California law that purported to regulate out-of-state disposal of medical waste that originated in California. The court noted the “two emanations” of the dormant Commerce Clause, which govern discrimination and direct extraterritorial regulation, respectively. The court stated that “there can be no doubt that the Department officials sought to punish [the plaintiff] for disposing of medical waste in a manner that was perfectly legal in the states in which [the plaintiff] had effectuated disposal.” Thus, the plaintiff would “likely succeed on its claim that the Department officials’ application of the [statute] constitute[d] a per se violation of the Commerce Clause.” Further, “the mere fact that some nexus to a state exists will not justify regulation of wholly out-of-state transactions.” Thus, the Ninth Circuit affirmed the injunction against further enforcement.

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75. *Id.* at 1323–24.
76. *Id.* at 1323.
77. *Daniels Sharpsmart, Inc. v. Smith*, 889 F.3d 608 (9th Cir. 2018).
78. *Id.* at 614.
79. *Id.* at 616.
80. *Id.* The Ninth Circuit also cited the Supreme Court’s decision in *BMW v. Gore*, discussed earlier, reaffirming the linkage between Due Process Clause and Commerce Clause jurisprudence with respect to attempted extraterritorial regulation by the states. *Id.* at 616.
81. *Id.* at 615.
82. The foregoing discussion is not intended to suggest that dormant Commerce Clause challenges invariably have succeeded. For example, in *Rocky Mountain Farmers Union v. Corey*, 730 F.3d 1070 (9th Cir. 2013), the Ninth Circuit rejected an extraterritoriality challenge to Low Carbon Fuel Standard regulations promulgated by the California Air Resource Board under the authority of the California Global Warming Solutions Act. The court found that California did not thereby control out-of-state transactions. After a remand, this decision was reaffirmed in *Rocky Mountain Farmers Union v. Corey*, 913 F.3d 940 (9th Cir. 2019), principally on grounds of *res judicata*, although the court also rejected a reframed argument based upon “structural federalism” or the inherent nature of the relationship among the states under the Constitution. *Id.* at 953–54.
V. Analysis of the Washington Anti-Poaching Initiative

The Washington anti-poaching initiative cannot be sustained under the foregoing precedents. As Attorney General Ferguson has stressed in public statements, the campaign is intended expressly to regulate national behavior and has the goal of “eliminating no-poach clauses” from franchise agreements “nationwide.”83 There is no pretext that this campaign is attempting to resolve a Washington-based problem, with some incidental and unintended spillover effects outside its boundaries. Rather, Attorney General Ferguson is asserting unfettered authority to dictate the terms of franchise agreements nationwide, based solely on the fact that a franchisor at some point has sold a franchise in Washington. 84 This minimal nexus cannot support the vast national authority asserted, which would be essentially co-extensive with the authority of the federal government.

Although the precise limits may be difficult to ascertain in close cases, the Supreme Court’s dormant Commerce Clause and Due Process Clause jurisprudence unequivocally rejects the proposition that states have free reign to regulate commercial conduct that occurs beyond their borders. As the Court explained in BMW v. Gore, no state may “impose its policy choice on neighboring States.” 85 Contrary to this fundamental tenet of federalism, Washington is improperly attempting to impose its policy preferences not just on “neighboring States,” but on every state. And Washington thereby is preempting the constitutionally protected authority of other states “to make [their] own reasoned judgment about what conduct is permitted or proscribed within [their] borders.” 86

A state’s “direct regulation” or “direct control” of out-of-state transactions constitutes a per se violation of the Commerce Clause under the Supreme Court’s decisions in Edgar v. MITE Corp., Brown-Forman, and Healy v. Beer Institute. Here, Washington’s assertion of “direct control” over out-of-state transactions is beyond question and far clearer than with the more subtle price-affirmation statutes invalidated in Brown-Forman and Healy. In this respect, the situation is more like the Indiana statute invalidated in Legato Vapors, the Maryland price gouging statute invalidated in Ass’n for Accessible Medicine v. Frosh, the California resale royalty law invalidated in Sam Francis Foundation v. Christies, and the California medical disposal law invalidated in Daniels Sharpsmart. 87 Each of these statutes, either directly or through

83. Press Release, supra note 3.
84. According to a press release issued by the Washington Attorney General’s office, at least one out-of-state franchisor that was the target of his investigation and reached a settlement did not have any of its own stores or any franchisees in Washington. Id. (noting that one chain had “no Washington locations, estimated 233 locations nationwide”). Thus, even the fig leaf of a Washington nexus was absent.
87. Because of the assertion of direct control, there is no need to speculate as to “practical effects” that also could support invalidation under Brown-Forman. See Brown-Forman Distillers Corp. v. N.Y. State Liquor Auth., 476 U.S. 573, 583 (1986).
associated administrative proceedings, purported to impose, on behalf of a state, demands on out-of-state transactions. None survived scrutiny under the dormant Commerce Clause.88

Where the Washington State government demands the omission of a particular provision from a franchise agreement in situations in which neither the franchisor nor the franchisee is based in Washington, there is also a plain violation of the rule that forbids “[f]orcing a merchant to seek regulatory approval in one State before undertaking a transaction in another.”89 Under the principles established by the framers of the Constitution, and reflected in decisions of the Supreme Court and the federal circuit courts, the state of Washington should have no say regarding the terms of a franchise agreement between a New Jersey franchisor and a Virginia franchisee. Thus, the attorney general of Washington has no authority to dictate the terms of these agreements, as he has sought to do.

The Washington initiative likewise cannot be defended on the basis of purported effects on the labor market in Washington. First, as the Supreme Court has held, “The Commerce Clause . . . precludes the application of a state statute to commerce that takes place wholly outside of [a] State’s borders, whether or not the commerce has effects within the State.”90 Second, in addition to its legal irrelevance, a claim that the existence of an anti-poaching provision in a franchise agreement between a Florida franchisor and a Florida franchisee would somehow affect the labor market three thousand miles away in Washington State is, at best, highly improbable. As one district court considering an anti-poaching claim against a franchisor observed, “Realistically, only restaurants within the same locale compete for employees.”91 Finally, if such attenuated assertions of local effects could save express regulation of out-of-state conduct from invalidation under the dormant Commerce Clause, the doctrine would essentially be nullified. Indeed, in every case discussed in this article where the court invalidated a statute, there were more pronounced local effects than Washington could assert here. As the

88. To the extent that Attorney General Ferguson has relied upon any particular statutory authority for his initiative, it appears to be Washington’s general antitrust statute. See Complaint ¶ 30, Washington v. Jersey Mike’s Franchise Sys., Inc., No. 18-2-25822-7 SEA (King Cty. Super. Ct. filed Oct. 15, 2018) (alleging violation of RCW § 19.86.030). That statute has broad applicability and obviously is not invalid in its entirety. However, dormant Commerce Clause precedent makes clear that courts can preclude invalid applications of state statutes. See Legato Vapors, LLC v. Cook, 847 F.3d 825, 837 (7th Cir. 2017) (holding that “[a]s applied to out-of-state manufacturers, the challenged extraterritorial laws violate the Commerce Clause”); Sam Francis Found. v. Christie’s, Inc., 784 F.3d 1320, 1325 (9th Cir. 2015) (holding that “the Act’s regulation of out-of-state sales runs afoul of [the dormant Commerce Clause]; accordingly, we must strike that portion of the Act as an impermissible regulation of wholly out-of-state commerce”); Daniels Sharpsmart, Inc. v. Smith, 889 F.3d 608, 616 (9th Cir. 2018), (affirming preliminary injunction prohibiting administrative enforcement of statute against out-of-state conduct). The dormant Commerce Clause thus serves as a limitation on the power of the state that cannot be circumvented.

89. Brown-Forman, 476 U.S. at 582.


Fourth Circuit stated in *Ass’n for Accessible Medicine v. Frosh*, “Any legitimate effects the Act may have [within the state] are insufficient to protect the law from invalidation.”92 Thus, even purported beneficial local effects cannot save the Washington anti-poaching initiative.

The state of Washington also cannot defend its initiative by alleging that elimination of anti-poaching provisions in franchise agreements is in the national interest. The Supreme Court has made clear that the national interest must be pursued by the federal government, not a state. As the Court held in *Edgar v. MITE Corp.*, “[T]he State has no legitimate interest in protecting nonresident[s].”93 More generally, regulatory choices in other states are left to those states and their elected officials, not the elected officials in the state of Washington. As Judge Posner pointed out in striking down an Indiana statute on dormant Commerce Clause grounds, allowing one state to force application of its law over the contrary laws of other states “would be arbitrarily to exalt the public policy of one state over that of another.”94

In the federal system, state power “is constrained by the need to respect the interests of other States.”95 And, as discussed in Part I above, there is no national consensus, let alone a governing national law, regarding anti-poaching provisions in franchise agreements.96

Because it directly regulates out-of-state transactions, the Washington anti-poaching initiative would likely be struck down summarily under the dormant Commerce Clause, without any detailed balancing of interests. But even if a court conducted a *Pike v. Bruce Church* balancing test, the Washington initiative would fail. Under this test, a state statute “must be upheld 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.’”97 While the Washington initiative regulates evenhandedly, the extraterritorial aspects do not “effectuate a legitimate local public interest.” The effects on interstate commerce, including the terms of franchise agreements that have no connection whatsoever to the state of Washington, are far from “incidental.” And the intrusion on interstate commerce outweighs any “putative local benefits.” In sum, under any applicable standard, the Washington attorney general’s national anti-poaching initiative violates the dormant Commerce Clause.

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92. *Ass’n for Accessible Medicines v. Frosh*, 887 F.3d 664, 672 (4th Cir. 2018).
94. Midwest Title Loans, Inc. v. Mills, 593 F.3d 660, 668 (7th Cir. 2010).
96. Of course, Attorney General Ferguson is free to seek to advocate his position and seek to build a national consensus, as he has done by joining the Comments submitted to the FTC by the “18 State Attorneys General.” See Public Comments of 18 State Attorneys General on Labor Issues in Antitrust *supra* note 21. But that effort at persuasion is distinct from unilateral enforcement of Washington law nationwide.
Compelling U.S. Discovery in International Franchise Arbitrations: The (F)utility of Section 1782 Applications

Matthew J. Soroky

With the increasingly globalized franchise market comes an increasing number of international disputes among franchisors, master franchisees, franchisees, and developers. The rules and procedures of cross-border arbitration have been said to be “tailor-made” to resolve such international franchise disputes.1 So it is no surprise that international arbitration is on the rise. A 2018 survey shows 92% of in-house lawyers report international arbitration as their preferred method of dispute resolution.2 Leading global arbitral institutions report year-over-year increases in cases filed, including a 28% increase from 4,130 in 2012 to 5,661 in 2016.3 As of 2018, over 150 countries including the United States are signatories to the New York Convention,4 which provides that arbitration awards involving foreign parties are enforceable by federal courts.5 New York and California have recently spearheaded efforts to attract and capture larger shares of the international arbitration market.6

5. 9 U.S.C. § 201 et seq.
6. See Tractenberg, supra note 1, at 452 (“For example, the New York International Arbitration Center (NYIAC) was launched in 2013 to provide needed space to conduct arbitrations administered by other agencies. Only three months later, the International Chamber of Commerce (ICC) established a presence in New York.”). In 2018, California passed new rules—and designedly one of the most inclusive sets of such rules in the world—to permit out of state and foreign attorneys to appear in international commercial arbitrations seated in California. See Chang, supra note 2, at 31–32.

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But international arbitration is markedly different from commercial arbitration in the United States. Unless the franchisor’s arbitration clause provides for the arbitrator’s authority to issue document subpoenas, compel witnesses to testify in a deposition, and other facets of broad American-style discovery, such evidence gathering is limited and often restricted entirely by most international arbitration rules. The default provisions under most of these rules require parties to exchange the information they intend to rely on, but the procedure involves little to no adversarial or third-party discovery.

This article examines a disparity among U.S. courts on the question whether discovery in the United States may be compelled in aid of international franchise arbitrations pursuant to 28 U.S.C. § 1782 (§ 1782). The origin of the split can be traced to the U.S. Supreme Court’s only opinion on § 1782, and the limits of discretion courts may exercise under it, Intel v. Advanced Micro Devices, Inc., 542 U.S. 241 (2004) (Intel). As described by one district court, the split is rooted in disagreement over “[t]wo words from a law review article quoted by the Supreme Court in support of a different proposition...”10 Following Intel’s broad interpretation of the statute, substantial numbers of requests for judicial assistance under § 1782 in aid of international arbitrations have been litigated in U.S. courts. Understanding the reasons courts have chosen to either grant or deny such assistance to international arbitrations is critical for franchise counsel tasked with drafting the arbitration clause in international franchise agreements, or gathering evidence located in the United States that bears on the outcome of a franchise dispute between two foreign parties.

I. Section 1782 Text and Policy

Titled “Assistance to foreign and international tribunals and to litigants before such tribunals,” the text of § 1782 provides, in relevant part:

The district court of the district in which a person resides or is found may order him to give his testimony or statement or to produce a document or other thing for use in a proceeding in a foreign or international tribunal. . . . The order may be made . . . upon the application of any interested person and may direct that

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7. See Tractenberg, supra note 1.
8. See Cedric Chao, Kerry Bundy, Isaac Hall & Jay Munisteri, It’s All Greek to Me—Navigating the Unfamiliar Waters of International Arbitration, INT’L FRANCHISE ASS’N 49TH ANN. LEGAL SYMPOSIUM (2016) (“International arbitration is generally characterized by limited discovery (called ‘disclosures’ in the international arbitration world), finding its roots in civil law traditions, which eschew the sweeping discovery characteristic of litigation in the United States.”).
9. Id
The testimony or statement be given, or the document or other thing be produced, before a person appointed by the court. . . . 12

The “twin aims” of §1782 are (1) to provide efficient judicial assistance from federal district courts in gathering evidence for litigants outside of the United States, and (2) to encourage, by example, foreign countries to provide similar means of assistance to U.S. courts. 13 In addition to other factors announced in Intel, courts are ultimately guided by these twin aims in exercising discretion to provide appropriate assistance to international litigants. 14

A. The Conundrum of Section 1782 in Franchise Transactions

In the fifteen years since the Court’s seemingly liberalized interpretation of §1782, courts have grappled with §1782’s application to various government-based and contract-based arbitral proceedings. When the “international tribunal” is investor-state arbitration tribunal (i.e., proceedings conducted pursuant to bilateral or multilateral investment treaties), lower courts uniformly hold such a “tribunal” is eligible for §1782 aid. 15 But in an international franchise arbitration between private parties, where a government or state sponsor is absent, they remain divided on whether Intel’s expansive reading of §1782 and its policy goals are sufficient for the term “tribunal” to encompass contractual arbitral proceedings. 16 Although courts have sharply disagreed over the precedential effect of Intel on the question of whether a “foreign or international tribunal” under §1782 includes private commercial arbitration, there has been a remarkable shift in recent cases, including document requests in an international franchise dispute, ushering a new prevailing view that private arbitration is not a proper §1782 tribunal. Then, just this fall, the Court of Appeals for the Sixth Circuit reinvigorated the debate by holding that private arbitration is a proper §1782 tribunal. 18 Several other Courts of Appeals are set to address the issue. 19

16. Multiple courts have concluded that even if state-sponsored arbitrations were within the scope of §1782, purely private arbitrations are not. See, e.g., In re Arbitration, 626 F. Supp. 2d 882, 885 (N.D. Ill. 2009) (“I interpret the Intel Court’s reference to ‘arbitral tribunals’ as including state-sponsored arbitral bodies but excluding purely private arbitrations.”); In re Application of Prabhat K. Dubey, 949 F. Supp. 2d 990 (C.D. Cal. 2013) (“[T]he Court is convinced that a ‘reasoned distinction’ can be made between purely private arbitrations established by private contract and state-sponsored arbitral bodies. . . .”).
Conflict in the courts is a challenge for any international “outbound” or “inbound” franchise transaction that relies on arbitration to resolve disputes, where the likelihood of documents and witnesses being located in the United States is high. The uncertainty of judicial assistance from a U.S. district court makes it difficult to predict whether a franchisor’s affiliate, an operating company, a domestic franchisee association, a master franchisee tasked with local development of a foreign brand, its local affiliates, or any number of interested parties likely to be found in the United States can be compelled to release discovery. A historical review of § 1782 jurisprudence can reveal the insights and trends that suggest whether an application to take discovery in the United States will be granted or denied.

B. Section 1782 Procedure and Requirements

Three mandatory elements of §1782 must be satisfied for a federal district court to compel discovery within the U.S. in aid of a foreign proceeding: (1) the person or entity from whom discovery is sought “resides or is found in” the district in which the application is filed; (2) the discovery is “for use in a proceeding in a foreign or international tribunal”; and (3) the application is made by a foreign or international tribunal, or by “any interested person.”

If these statutory requirements are satisfied, district courts then examine four factors, outlined in Intel, to guide them in exercising discretion to grant or deny a §1782 application: (1) whether the person from whom the discovery is sought is a participant in the foreign proceeding; (2) the nature of the foreign tribunal, the character of the proceedings underway abroad, and the receptivity of the foreign government or the court or agency abroad to U.S. federal court assistance; (3) whether the §1782 request conceals an attempt to circumvent foreign proof-gathering restrictions or policies; and (4) whether the request is unduly intrusive or burdensome.

II. 1999: Pre-Intel Precedent

In 1999, two courts of appeals ruled against the application of §1782 to arbitral tribunals. In NBC v. Bear Stearns & Co. (NBC), the Second Circuit held that private arbitrations are not foreign or international tribunals under §1782. The Fifth Circuit followed suit in Republic of Kazakhstan v. Biedermann International (Biedermann). Each sets forth the principal reasons for excluding private arbitration from §1782 often relied upon by the district courts.

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21. Id. at 264–65.
23. Republic of Kazakhstan v. Biedermann Intl, 168 F.3d 880 (5th Cir. 1999). NBC involved a commercial arbitration panel in Mexico administered by the International Chamber of Commerce under ICC rules and Mexican law, and Biedermann involved a proceeding before the Arbitration Institute of the Stockholm Chamber of Commerce.
First, the Second Circuit noted the absence of any reference to private arbitration tribunals. It held that “the fact that the term ‘foreign or international tribunals’ is broad enough to include both state-sponsored and private tribunals fails to mandate a conclusion that the term, as used in § 1782, does include both.”\textsuperscript{24} Section 1782’s legislative history reveals that Congress intended to cover “governmental or intergovernmental arbitral tribunals and conventional courts and other state-sponsored adjudicatory bodies.”\textsuperscript{25} Reviewing a reference in the 1964 revisions to a “foreign administrative tribunal or quasi-judicial agency,” the court concluded “there is no indication that Congress intended for the [statute] to reach private international tribunals” and that this “silence with respect to private tribunals is especially telling because . . . a significant congressional expansion of American judicial assistance to international arbitral panels created exclusively by private parties would not have been lightly undertaken by Congress without at least a mention of this legislative intention.”\textsuperscript{26}

Other bases to exclude private international arbitration from §1782 is that the discovery afforded by §1782 would be at odds with the fundamental purposes of private arbitration.\textsuperscript{27} The Fifth Circuit noted that “[e]mpowering arbitrators, or worse, the parties, in private international disputes to seek ancillary discovery through the federal courts does not benefit the arbitration process. Arbitration is intended as a speedy, economical, and effective means of dispute resolution.”\textsuperscript{28} Finally, the Second Circuit also noted the apparent conflict §1782 would pose with limited evidence gathering mechanisms in domestic arbitrations provided under section 7 of the Federal Arbitration Act.\textsuperscript{29}

III. 2004: U.S. Supreme Court Interprets Section 1782

The Supreme Court explored the parameters of §1782 in the Intel case. AMD filed an antitrust complaint against Intel with the Directorate-General for Competition of the Commission of the European Communities (DG-Competition).\textsuperscript{30} The DG-Competition is the EU’s primary enforcer of antitrust regulations.\textsuperscript{31} In pursuit of its antitrust complaint—and when the DG-Competition declined to request discovery in its investigation—AMD applied to the U.S. District Court for the Northern District of California, invoking §1782 for an order requiring Intel to produce documents that Intel

\textsuperscript{24} NBC, 165 F.3d at 188.
\textsuperscript{25} Id. at 190.
\textsuperscript{26} Id. (citing H.R. Rep. No. 88-1052, at 9 (1963); S. Rep. No. 88-1580, at 3788–89 (1964)).
\textsuperscript{27} Id.
\textsuperscript{28} Biedermann, 163 F.3d at 883.
\textsuperscript{29} NBC, 165 F.3d at 191.
\textsuperscript{31} Id.
produced in another domestic antitrust lawsuit. The district court concluded §1782 did not authorize such discovery. The Ninth Circuit reversed and remanded with instructions to rule on the application’s merits. On petition for certiorari, the Supreme Court considered four questions regarding the scope of §1782: (1) whether a non-litigant complainant before the European Commission is an “interested person” under §1782; (2) whether the proceeding before the European Commission qualified as a “tribunal”; (3) whether a proceeding must be pending or imminent for an applicant to invoke §1782; and (4) whether §1782 contains a foreign-discoverability requirement.

Justice Ginsburg, writing for a 7-to-1 majority, answered the first two questions in the affirmative and the latter two questions in the negative. Each analyzed element broadened the general reach of §1782 in international litigation. An “interested person” need not be a named litigant or party to a proceeding before the international tribunal. It includes anyone, such as litigants and foreign officials, who has a reasonable interest in obtaining the information requested. A “proceeding” for which discovery is sought must be within reasonable contemplation, but need not be “pending” or “imminent.” And a district court may order discovery despite the fact that the documents would not be discoverable if they were located in the foreign jurisdiction.

In determining the second question—whether the proceeding before the European Commission qualified as a “tribunal”—the court described the “complete revision” §1782 had undergone in 1964: “Congress deleted the words ‘in any judicial proceeding pending in any court in a foreign country,’ and replaced them with the phrase ‘in a proceeding in a foreign or international tribunal.’” The Court reasoned that “Congress understood that change to provide the possibility of U.S. judicial assistance in connection with administrative and quasi-judicial proceedings abroad.” As further support for this proposition, the decision cited the Senate report and two footnotes from a law review article authored by Professor Hans Smit, who served as

32. Id. at 250–51.
33. Id. at 246.
34. Id. (citing Advanced Micro Devices, Inc. v. Intel Corp., 292 F.3d 664, 665 (9th Cir. 2002)).
36. Justice Breyer authored a dissenting opinion, suggesting an added limitation that courts “should pay close attention to the foreign entity’s own view of its ‘tribunal’-like or non-‘tribunal’-like status to better achieve Congress’ cooperative objectives in enacting the statute.” Intel, 542 U.S. at 267–73. Justice Scalia’s single-paragraph concurrence emphasized “the statute—the only sure expression of the will of Congress—says what the Court says it says” but criticized the majority for relying on words of a Senate Committee Report when the text of the statute was sufficient to arrive at the majority’s conclusion. Id. at 267. Justice O’Connor took no part in the consideration or decision of the case.
37. Id. at 256.
38. Id. at 258–59.
39. Id. at 260–63.
40. Id. at 248–49 (emphasis omitted).
41. Id. at 257–58 (formatting and quotation omitted).
The (F)utility of Section 1782 Applications


In the first years after Intel, district courts encountering § 1782 applications in aid of private international arbitrations found that such proceedings

42. Id. at 258 (citing Hans Smit, International Litigation Under the United States Code, 65 COLUM. L. REV. 1015, 1026–27 nn.71, 73 (1965)).
44. See Euromepa S.A. v. R. Esmerian, Inc., 51 F.3d 1095, 1099 (2d Cir. 1995) (describing Smit as “a chief architect” of §1782).
45. Id. (emphasis added)
46. Intel, 542 U.S. at 258
47. Id. at 266. On remand, the district court denied AMD’s amended §1782 application in full, finding that none of the four discretionary factors weighed in AMD’s favor, and noting that the application appeared to be an attempt to circumvent the DG-Competition’s decision not to pursue such discovery. See Advanced Micro Devices v. Intel Corp., 2004 WL 2282320, at *2–3 (N.D. Cal. Oct. 4, 2004).
48. For early post-Inel cases holding that an arbitral tribunal falls under §1782, see, for example, In re Winning (HK) Shipping Co., Ltd., 2010 WL 1796579, at *9–10 (S.D. Fla. Apr. 30, 2010) (noting that private arbitration in London subject to the English Arbitration act constituted a foreign tribunal under §1782); OJSC Uknafta v. Carpathsky Petroleum Corp., 2009 WL 2877156, at *4 (D. Conn. Aug. 27, 2009) (granting discovery in aid of an arbitration before the Stockholm Chamber of Commerce on the grounds that the tribunal was a first-instance decision-maker whose decision may be subject to judicial review); Comisión Ejecutiva, Hidroeléctrica del Río Lempa v. Nejapa Power Co. LLC, 2008 WL 4809035 (D. Del. Oct. 14, 2008) (Intel and post-Inel decisions indicate that §1782 applies to private foreign arbitrations); In re Babcock Borsig AG, 583 F. Supp. 2d 233, 239 (D. Mass. 2008) (private ICC arbitral panel falls within the meaning of §1782, but denying the motion to compel discovery on other grounds); In re Hallmark Capital Corp., 534 F. Supp. 2d 951 (D. Minn. 2007) (granting discovery in aid of an Israeli arbitration proceeding); In re Oxus Gold PLC, 2007 WL 1037387, at *5 (D.N.J. Apr. 2, 2007) (magistrate judge’s conclusion that arbitration between private litigants within a framework defined by investment treaty and governed by UNCITRAL Arbitration Rules not
under *Intel’s* analysis are per se “tribunals” within the plain meaning of §1782\(^49\) or come within the scope of the statute if the arbitral body in question satisfies the “functionality” test applied by *Intel*.\(^50\) These courts relied heavily on *Intel’s* attention to the substituted word “tribunal” in the 1964 revision of the statute, a broad interpretation of *Intel* as a whole, and *Intel’s* citation to Professor Smit’s view that the term “tribunal” includes “arbitral tribunals.”\(^51\) They found the Second and Fifth Circuits’ wholesale exclusions of private arbitration from §1782 applicability no longer persuasive after *Intel*\(^52\) and inconsistent with the Supreme Court’s aversion to imposing “categorical limitations” on §1782.\(^53\) In support of the “plain meaning” argument, one leading international arbitration scholar takes a practical approach to the argument that the plain language of §1782 extends to arbitral “tribunals”:

\<clearly erroneous or contrary to law>; *In re Roz Trading, Ltd.*, 469 F. Supp. 2d 1221 (N.D. Ga. 2006) (international commercial arbitration panel located in Austria was a tribunal under §1782 because the body acted as a first-instance decision-maker and issued decisions both responsive to a complaint and reviewable in court).

49. See, e.g., *Hallmark*, 534 F. Supp. 2d at 954 (opining that it is “best read not to impose any restrictive definitional exclusions that would necessarily preclude assistance to all private arbitral bodies”).


51. See cases cited supra note 48. Early post-*Intel* opinions afford great weight to the Supreme Court’s frequent citations to multiple articles written by Professor Hans Smit, specifically his statement that “arbitral tribunals” are included under the statute. *Intel*, 542 U.S. at 258 (citing Smit, supra note 42, at 1026–27 nn.71, 73). In a now-vacated opinion, the Eleventh Circuit in *Consorcio I* attributed the Supreme Court’s deference to the fact that Professor Smit is “more than a leading scholar in the field” and was “the dominant drafter of, and commentator on, the 1964 revision of 28 U.S.C. §1782,” as acknowledged by then-Judge Ginsburg in an earlier D.C. Circuit opinion. *Consorcio Ecuatoriano*, 685 F.3d at 996 (quoting *In re Letter of Request from the Crown Prosecution Serv. of the U.K.*, 870 F.2d 686, 689 (D.C. Cir. 1989)).

52. See, e.g., *Babcock*, 583 F. Supp. 2d at 239 (“I do not find the reasoning in [NBC] and *Biedermann* to be persuasive, particularly in light of the subsequent Supreme Court decision in *Intel*.”); *Roz Trading*, 469 F. Supp. 2d at 1226 (“Both of these cases were decided five years before *Intel*. Their reasoning, and particularly that of [NBC], is materially impacted by *Intel*.”); *Winning*, 2010 WL 1796579 at *7; *Hallmark*, 534 F. Supp. 2d at 956.

53. See, e.g., *Babcock*, 583 F. Supp. 2d at 240 (“[T]he Supreme Court in *Intel* repeatedly refused to place ‘categorical limitations’ on the availability of §1782(a). . . .”); *Hallmark*, 534 F. Supp. 2d at 956–57 (“*Intel’s* emphasis on giving district court’s discretion in evaluating merits of 1782 application is a means of achieving its legislative purpose, which is to disfavor categorical rules or exclusions.”).
Indeed, the contrary suggestions strikes most international arbitration practitioners as odd: it goes almost without saying that an arbitral tribunal, vested with adjudicatory powers and obligations, is a tribunal and that, in international matters, it is an international tribunal. There is nothing in the statute’s legislative history that would suggest a contrary interpretation.54

To date, at least one appellate court has adopted this argument.55 Similarly, in 2008, the Committee on International Commercial Disputes of the New York City Bar asserted in a report that “foreign or international tribunal” should be construed to include all international arbitral tribunals irrespective of location, with suggested “best practices” for how district courts might exercise their discretion under the Intel factors.56

V. 2009 to Present: Changing, Uneven Trends

Five years after Intel, the Fifth Circuit affirmed Biedermann in an unpublished decision.57 This apparently set the stage for a turning point, as other district courts receiving § 1782 applications, both around this time and subsequently, have overwhelmingly denied aid because the private arbitrations were not “foreign tribunals” under § 1782. These courts cite Intel’s silence on the matter, the fundamental differences between private arbitration and governmental or state-sponsored adjudicatory bodies (with emphasis on the limits or absence of judicial review), and the practical consequences of finding that private arbitration qualifies for § 1782 aid.58 One of the first

54. Born, supra note 11, § 16.03[A].
55. See Abdul Latif Jameel Transp. Co. v. FedEx Corp., 939 F.3d 710, 722 (6th Cir. 2019) (“American lawyers and judges have long understood, and still use, the word ‘tribunal’ to encompass privately contracted-for arbitral bodies with the power to bind the contracting parties.”).
57. See El Paso Corp. v. La Comision Ejecutiva Hidroeléctrica del Rio Lempa, 341 Fed. App’x 31, 34 (5th Cir. 2009) (finding that none of the concerns regarding the application of § 1782 to private international arbitrations was at issue or considered in Intel).
58. Id. at 34; In re Arbitration, 626 F. Supp. 2d 882, 885 (N.D. Ill. 2009) (“[A]lthough the Intel Court acknowledged the ways in which Congress has progressively broadened the scope [of] § 1782, it stopped short of declaring that any foreign body exercising adjudicatory power falls within the purview of the statute.”); In re Operadora DB Mexico, S.A. DE C.V., 2009 WL 2423138, at *11 (M.D. Fla. Aug. 4, 2009) (“This Court is confident that the Supreme Court would not have expanded §1782 to permit discovery assistance in private arbitral proceedings and reversed NBC and Biedermann—without even acknowledging their existence—in a parenthetical quotation supporting an unrelated proposition.”); La Comision Ejecutiva Hidroeléctrica Del Rio Lempa v. El Paso Corp., 617 F. Supp. 2d 481, 485 (S.D. Tex. 2008) (“[T]he Supreme Court has not addressed the application of §1782 to arbitral tribunals, not even in dicta.”); In re Grupo Unidos Por El Canal, 2015 WL 1810135, at *7 (D. Colo. Apr. 17, 2015) (Grupo Unidos CO) (“It is completely implausible that the Supreme Court would have, in a parenthetical quotation supporting an unrelated proposition involving an quasi-judicial governmental body, expanded §1782 to permit discovery assistance in private arbitral proceedings and reverse the only two circuits addressing this issue sub silentio, without even acknowledging the existence of the circuit precedent.”); In re Application by Rhodianyl S.A.S., 2011 U.S. Dist. LEXIS 72918, (D. Kan. Mar. 25, 2011) (“Because the ICC Panel’s authority derives from the parties’ agreement, its purpose is fundamentally different than that of a governmental or state-sponsored proceeding.”).
post-Inel cases, In re Operadora DB Mexico, S.A. DE C.V. (Operadora),59 denied §1782 aid to an international dispute over franchise rights to the “Hard Rock” brand in Mexico.

A. Operadora Court Denied Section 1782 Aid to Hard Rock Franchisee

The franchisee in Operadora was an entity incorporated under Mexico law. It entered into a Master Franchise Agreement (MFA) with Hard Rock Limited, a Jersey Channel Islands corporation.60 Both parties claimed exclusive franchise rights in Mexico to the “Hard Rock” mark.61 Hard Rock Limited initiated an arbitration constituted under the International Chamber of Commerce (ICC)’s International Court of Arbitration in Mexico City.62 The franchisee asserted that many of its communications and transactions regarding its franchise rights were with Hard Rock Limited’s Florida-based U.S. affiliate, Hard Rock Café International (HRCI), not Hard Rock Limited, and that HRCI was in possession of communications regarding the franchisee’s payment of royalties, participation in audits, and general correspondence.63 The franchisee invoked §1782 to seek an order from the U.S. District Court for the Middle District of Florida, authorizing issuance of a subpoena to HRCI for discovery relevant to the arbitration. It argued the arbitrator had no jurisdiction over HRCI to compel HRCI to produce documents to show that HRCI and Hard Rock Limited acknowledged the franchisee’s rights under the MFA. HRCI, on the other hand, urged the magistrate to follow pre-Inel precedent from the Second and Fifth Circuits to deny the franchisee’s application.64 The magistrate issued a report and recommendation to the district court to find that the private ICC panel qualified as a proper §1782 tribunal, entitling the franchisee to seek documents from HRCI.65

60. Id. at *1.
61. Id. at *1, n.2.
62. Id. The franchisee’s subpoena sought (1) Any and all documents which relate to, describe, summarize, constitute, or mention, the holder of any rights under the Master Franchise Agreement from January 1, 1994 to the present; (2) Any and all non-privileged documents which relate to, describe, summarize, constitute, or mention, in whole or in part, any royalties or payments made to Hard Rock Limited pursuant to the Master Franchise Agreement from January 1, 1994 to the present; (3) Any and all documents which relate to . . . internal communications between [HRCI] or Hard Rock Limited employees, agents, attorneys, or representatives pertaining to Operadora’s rights, or lack thereof, under the Master [sic] Franchise Agreement from January 1, 1994 to the present; (4) Any and all documents which relate to . . . communications between Hard Rock Limited and any third party pertaining to Operadora’s rights, or lack thereof, under the Master Franchise Agreement from November 20, 2006 to the present; (5) Any and all documents which relate to . . . communications and agreements between Hard Rock Limited and any third party, [as to] franchise rights for hotels in Mexico under the “Hard Rock” brand from November 20, 2006 to the present. Id. at *1, n.2.
63. Id.
64. Id. at *2.
65. Id. at *10. The magistrate declined to authorize a subpoena on Request No. 5 for communications and agreements Hard Rock Limited had with any third party concerning franchise rights for hotels in Mexico under the “Hard Rock” brand, finding such communications “likely,
The district court declined to adopt the magistrate’s recommendation. Relying on NBC and Biedermann’s “reasoned distinction” between purely private arbitrations established by private contract and state-sponsored arbitral bodies, the district court held that Intel’s reasoning is appropriately limited to state or governmental adjudicatory bodies. It rejected the emphasis that earlier post-Inel courts placed on the Supreme Court’s quotation of Professor Smit, reasoning that the reference to Professor Smit’s definition of “tribunal” was included only for the proposition that §1782 applies to quasi-judicial agencies and administrative courts. The district court went so far as quote Professor Smit elsewhere, asserting that “an international tribunal owes both its existence and its powers to an international agreement,” further suggesting that Congress did not contemplate private arbitral proceedings when it used that term.

B. Eleventh Circuit Reverses Itself on §1782 Applications.

Since Intel, the Eleventh Circuit was the first appellate court to decide this question. It initially concluded in 2012 that a private arbitration was a “foreign or international tribunal” because it met “the functional criteria articulated in Intel.” Two years later, the court withdrew this opinion on its own motion and substituted a new decision affirming the grant of discovery on alternative grounds. It held that the applicant’s pre-suit investigation to but not relevant to the issue of who owns the rights to the brand under the franchise agreement.” Id. at *1.

66. In re Operadora DB Mexico, S.A. de C.V., 2009 WL 2423138, at *11 (M.D. Fla. Aug. 4, 2009) (stating that Intel merely considered whether tribunal includes “quasi-judicial agencies” such as the European Commission, but not private international arbitrations); see also, Arbitration in London, 626 F. Supp. 2d at 885 (same); Dubey, 949 F. Supp. 2d at 993–994 (same).

67. Operadora, 2009 WL 2423138 at *11 (“This Court is confident that the Supreme Court would not have expanded §1782 to permit discovery assistance in private arbitral proceedings and reversed NBC and Biedermann—without even acknowledging their existence—in a parenthetical quotation supporting an unrelated proposition. . . .”); see also In re Grupo Unidos Por El Canal, 2015 WL 1810135, at *8 (D. Colo. Apr. 17, 2015) (“This court finds that [Roz Trading, Hallmark and Babcock] relied too heavily on the Supreme Court’s inclusion of the phrase ‘arbitral panel’ in a parenthetical quotation and a definition in one treatise which would make sweeping changes to the jurisprudence surrounding §1782 not presented squarely to the Supreme Court in its case.”); Dubey, 949 F. Supp. 2d at 994–95 (same); El Paso Corp., 341 Fed. App’x at 34 (“Nothing in the context of the quote suggests that the Court was adopting Smit’s definition of ‘tribunal’ in whole.”); In re Application of Grupo Unidos Por El Canal S.A., 2015 WL 1815251, at *11 (N.D. Cal. Apr. 21, 2015) (“[T]he Supreme Court cited [Smit] merely to support the proposition that §1782 applies to administrative and quasi-judicial proceedings.”).

68. La Comision, 617 F. Supp. 2d at 486–487.


71. In re Consorcio Ecuatoriano de Telecomunicaciones S.A. v. JAS Forwarding (USA), Inc., 685 F.3d 987, 996 (11th Cir. 2012).

72. Id.
develop potential criminal and civil claims in a separate foreign tribunal was within reasonable contemplation under Intel. In escaping the hotly contested “tribunal” issue, the Eleventh Circuit expressly declined to answer the question of whether a private arbitration can be considered a tribunal under §1782 because it did not have a sufficiently developed record on the nature of the arbitration tribunal in question.

C. Recent Conflict Within the Southern District of New York

Dating back to the Eleventh Circuit’s now-vacated opinion, the number of post-Intel cases that would deny §1782 aid to international franchise arbitrations appears to be growing. As one example, in 2015, two district courts responding to a coordinated request for discovery located in California and Colorado for the same arbitration, decided within days of each other that a contract-based arbitral tribunal is not the type of “tribunal” Congress intended in 1964 when it substituted “foreign or international tribunal” in place of “foreign judicial proceedings.” Other recent decisions concur in the holdings of NBC and Biedermann regarding the ambiguity of the statutory language, the clearer instruction of the legislative history, and policy considerations in those opinions.

In spite of this tendency, four post-Intel cases in the Southern District of New York—three of them decided within last year—are evenly split in examining the question of whether Intel overruled NBC’s holding that a

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73. In re Consorcio Ecuatoriano de Telecomunicaciones S.A. v. JAS Forwarding (USA), Inc., 747 F.3d 1262, 1270 (11th Cir. 2014) (Consorcio II). Conecel, a supplier of cell phones and accessories, was defending a pending arbitration that arose from a billing dispute with its foreign logistics company and sought discovery from the respondent’s affiliate in Miami. Conecel’s §1782 application contemplated civil and private criminal suits against two of its former employees who, Conecel claimed, may have violated Ecuador’s collusion laws in processing the respondent’s allegedly inflated invoices.

74. See id. at 1270 n.4 (“We decline to answer [whether the arbitration is a ‘tribunal’ on the sparse record found in this case. The district court made no factual findings about the arbitration and made no effort to determine whether the arbitration proceeding in Ecuador amounted to a §1782 tribunal... Thus we leave the resolution of the matter for another day.”).

75. See cases cited supra note 58 and infra note 77.


77. In re Dubey, 949 F. Supp. 2d 990 (C.D. Cal. 2013); In re Servotronics, Inc., 2018 WL 5810109, at *4 (D.S.C. Nov. 6, 2018) (“And other than its passing mention when defining the word ‘tribunal,’ the Intel Court did not specifically discuss arbitral tribunals, much less private arbitral tribunals. As such, the Intel decision did nothing to alter [NBC] and [Biedermann] holdings that §1782 does not apply to private international arbitrations.”); In re Gov’t of the Lao People’s Democratic Republic, 2016 WL 1389764, at *4 (D. N. Mar. I. Apr. 7, 2016) (“This Court does not agree that Intel abrogated NBC and Biedermann, and instead holds that private arbitral bodies are categorically excluded from §1782’s coverage”); TJAC Waterloo, LLC ex rel. Univ. of Notre Dame (USA) in England, 2016 WL 1700001, at *2 (N.D. Ind. Apr. 27, 2016) (holding that purely private nature of proceeding and lack of available judicial review dictated private arbitration was “not a tribunal within the scope of §1782 and this Court lacks jurisdiction to order discovery...”).
private arbitral body is not a §1782 tribunal.78 In *Ex parte Application of Kleimar N.V.*, the district court was asked to determine whether a series of arbitrations before the London Maritime Arbitrators Association (LMAA) were eligible §1782 tribunals.79 The court relied on *Consortio I* and other decisions specifically holding the LMAA qualifies a foreign tribunal.80 Recognizing the post-*Intel* skepticism among district courts, a second judge in the Southern District of New York followed *Kleimar* in holding that the London Court of International Arbitration (LCIA) likewise was covered by §1782.81

The latter two cases in this district went the other way and held *NBC* remains good law in the Second Circuit,82 relying on precedent that on-point decisions in the court of appeals may not be abrogated sub silencio.83 The most recent, *In re Petrobras Securities Litigation*,84 notably disavows the weight afforded by other cases to Professor Smit, highlighting that Professor Smit wrote another law review article two years before Congress revised the statute, in which he expressed the view that “an international tribunal owes both its existence and its powers to an international agreement.”85 The court said the statement reflects an apparent belief that §1782 did not apply to private arbitral bodies at the time he wrote the words that the Supreme Court would later quote. It is implausible, then, to read the Supreme Court’s approving quotation of him as an endorsement of the opposite view.86 With multiple conflicting decisions in a relatively short period, the Second Circuit was recently asked to revisit its holding in *NBC* to resolve post-*Intel* uncertainty.87

D. Sixth Circuit Creates a Split of Authority Among Circuit Courts

Diverging from the reasoning of *NBC* and *Biedermann*, the *Fedex Corp.* decision is the first post-*Intel* case to hold that a private arbitral tribunal was

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80. *Id.* at 521–22.


83. *See Monsanto v. United States*, 348 F.3d 345, 351 (2d Cir. 2003) (stating that district courts are “required to follow” on-point Second Circuit precedent “unless and until that case is reconsidered by [the Second Circuit] sitting in banc (or its equivalent) or is rejected by a later Supreme Court decision”).


85. Smit, supra note 44 at 1267, cited in *NBC v. Bear Stearns & Co.*, 165 F.3d 184, 190 (2d Cir. 1999), and *Petrobras*, 393 F. Supp. 3d at 386.

86. *Petrobras*, 393 F. Supp. 3d at 386.

eligible for § 1782 discovery.88 The appellant, Abdul Latif Jameel Transportation Company (ALJ), was a delivery services partner of FedEx International in Saudi Arabia.89 A dispute arose when ALJ claimed that it was tricked into entering the relationship and that FedEx wrongly failed to renew their first contract.90 ALJ filed a discovery application under Section 1782 for discovery in aid of two foreign arbitrations—one that ALJ commenced in Saudi Arabia under Saudi law and rules, and the other FedEx International commenced in Dubai under DIFC-LCIA rules.91 ALJ sought documents and a deposition from FedEx Corp., the parent company of FedEx International.92

In reversing the district court’s decision to deny ALJ’s application and remanding for consideration of the Intel discretionary factors, the Sixth Circuit held that § 1782(a) permitted discovery for use in the private DIFC-LCIA arbitration at issue, after consideration of the statutory text, the meaning of the text based on legal and English definitions and usage of the term “tribunal” in 1964, and the statutory context and history of § 1782.93 Even if the reference to the two words “arbitral tribunals” in Professor Smit’s article was mere dicta, the Sixth Circuit’s reasoning was supported by Intel because the Supreme Court primarily focused the substitution of a broader phrase “foreign or international tribunal” for the specific phrase “judicial proceeding in a foreign country,” and emphasized the decision-making power of the DG-Competition to conclude the proceeding in Intel was a “tribunal.”94 The Sixth Circuit believed NBC and Biedermann “turned to legislative history too early in the interpretation process,”95 and that policy and efficiency implications of expanding discovery to private international arbitral tribunals, in view of the permissive nature of § 1782 and the discretionary factors to be considered, were insufficient to categorically bar private international arbitrations.96

VI. How Does the Tribunal Function?

Setting aside the debate over § 1782’s plain meaning and whether a bright-line rule includes or excludes private international arbitration, recall that Intel examined the function and procedures of the European Commission

89. Id.
90. Id. at 715.
91. Id. at 716. The arbitration seated in Saudi Arabia was dismissed, while the Dubai arbitration would proceed to a hearing in November 2019. ALJ requested an expedited appeal of the district court decision.
92. Id.
93. See id. at 717-23.
94. Id. at 725 & n.9.
95. Id. at 726.
96. Id. at 728-730.
in determining whether it qualified as a §1782 tribunal. Relying on this approach, lower courts have conducted a “functional” analysis to determine whether the arbitration contains the characteristics of a tribunal. The functionality test examines the following factors:

- Whether the arbitral panel acts as a first-instance adjudicative decision-maker;
- Whether it permits the gathering and submission of evidence;
- Whether it has the authority to determine liability and impose penalties; and
- Whether its decision is subject to judicial review.

Courts primarily disagree on the judicial review factor, particularly the degree of judicial reviewability that is appropriate to constitute a tribunal. According to some cases, the limited review afforded for procedural irregularities is sufficient. The Eleventh Circuit mentioned that “[o]ne could not seriously argue that, because domestic arbitration awards are only reviewable in court for limited reasons (notably excluding a second look at the substance of the arbitral determination), this amounts to no judicial review at all,” and found “no sound reason to depart from the commonsense understanding that an arbitral award is subject to judicial review when a court can enforce the award or can upset it on the basis of defects in the arbitration proceeding or in other limited circumstances.” The Sixth Circuit similarly noted that review of awards under the FAA is considered “judicial review.” Under this view, enforcement of any international arbitration award under the New York Convention is a kind of judicial review that may enable any arbitration between parties hailing from signatory nations to satisfy the functionality test.

98. See cases cited supra notes 48, 50.
101. In re Consorcio Ecuatoriano de Telecomunicaciones S.A. v. JAS Forwarding (USA), Inc., 685 F.3d 987, 996 (11th Cir. 2012); see also Roz Trading, 469 F. Supp. 2d at 1225 (because the arbitration proceeding was a first-instance decision-maker that issues decisions “both responsive to the complaint and reviewable in court,” it must necessarily be considered a tribunal); Winning, 2010 WL 1796579, at *8–10 (S.D. Fla. Apr. 30, 2010) (conducting functional analysis and concluding that arbitration in London was a foreign tribunal because the arbitration award is reviewable by English courts); OJSC Ukrnafta, 2009 WL 2877156, at *4 (because the Stockholm arbitration governed by UNCITRAL is subject to judicial review, it is a first-instance decision maker falling under the purview of §1782).
102. Consorcio Ecuatoriano, 685 F.3d at 996.
103. Id. at 996–97.
On the opposite extreme, other courts require a more in-depth, appellate-level review of the merits. In *Operadora*, the trial court applied this functional analysis to the ICC panel and found that “[t]he ICC Court is itself a creature of contract and may only modify the form of the ICC panel’s award, not its substance . . . The ICC panel is the product of the parties’ contractual agreement and its authority to issue binding decisions arises from that contract.” This group of opinions presumes that an international arbitration award is generally enforceable under the New York Convention. True judicial review is met, for purposes of §1782, where an arbitration award may be “set aside in extremely limited circumstances, such as for a lack of jurisdiction, a failure of the tribunal to abide by its mandate, or a violation of due process or international public policy.” Some §1782 decisions have altogether declined to apply this test.

### VII. Takeaways for Franchisors, Franchisees, and Developers

Lower court decisions on the type of international arbitral tribunals encompassed by §1782 have been characterized as “divergent and, in a number of instances, confused and the international arbitral process would benefit from clarification of the meaning of §1782 by U.S. appellate courts.”

Until that day comes, there are several measures one can take to increase

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105. *In re Operadora DB Mexico, S.A. de C.V.*, 2009 WL 2423138 at *9–10 (M.D. Fla. Aug. 4, 2009) (While some *Intel* attributes applied—such as the arbitrator’s ability to gather evidence, apply the law, and enter a binding decision—the arbitration did not function as a tribunal because the final decision was not judicially reviewable and the *Intel* court did not consider the source of the arbitration panel’s authority, which was the product of a contractual agreement); *In re Arbitration*, 626 F. Supp. 2d 882, 886 (N.D. Ill. 2009) (noting that the arbitral tribunal did not fall within the *Intel* definition because “private arbitrations are generally considered alternatives to, rather than precursors to, formal litigation” and “the very narrow circumstances in which the Board’s decisions may be subject to review does not allow for judicial review of the merits of the parties’ dispute”); *In re FinserveGrp.*, 2011 U.S. Dist. LEXIS 121521, at *3 (D.S.C. Oct. 20, 2011) (Because London Court of International Arbitration Rules waives judicial review, “the Court questions whether [it] would be considered a ‘foreign tribunal’ under the statute . . .”).


108. See, e.g., *Dubey*, 949 F. Supp. 2d at 994 n.3 (“[T]he Court is not convinced that *Intel* authorizes §1782 to apply to any type of proceeding that falls within its ‘functional’ definition of a tribunal, as suggested by some post-*Intel* decisions.”); *Grupo Unidos CA*, 2015 WL 1815251, at *11 n.8 (“A federal court should be able to determine that certain types of decision-making forums are outside the purview of §1782 without having to engage in an inefficient, resource-consuming functional analysis. For example, a federal court should be able to reject a §1782 application from a caucus of Belgian private school students empowered to arbitrate a dispute arising under their academic rules without having to first consider the caucus’ role as a first-instance decisionmaker.”).

109. Born, *supra* note 11, §16.03[A]. Regarding confusion among the lower courts, Born criticizes suggestions in *OFSC Ukrnafta* and *Oxus Gold* that international arbitrations conducted pursuant to UNCITRAL Arbitration Rules are “public” and encompassed by §1782, because such rules have no legal force unless incorporated into the parties’ arbitration agreement. *Id.* at 2414 n.440.
the likelihood that courts will aid in evidence gathering for international franchise disputes.

For the international franchisor or master franchisee engaging in a transaction with a person or entity that has nonsignatory affiliates in the United States, the foreign party would want to insist that the arbitration clause should provide for an institution and accompanying set of rules that enable review of the panel's award by the local court, and for limited reasons. For example, there is precedent for the argument that proceedings before the London Maritime Arbitrators Association (LMAA) constitutes a foreign tribunal under §1782 because awards by the LMAA are reviewable by the English Courts. An award issued by an LMAA panel can be challenged or appealed if a “serious irregularity” can be shown, or on a question of law arising out of an award. Such limited rights of appeal should not be excluded by the international arbitration clause if the circumstances of the franchise transaction suggests a §1782 application is likely to be sought. In contrast to the LMAA, default rules of the ICC's International Court of Arbitration and the LCIA exclude the right of appeal on the merits, without further provision in the agreement. The ICC is perhaps one of the most widely known international commercial arbitration institutions, but carries risk of precedence adverse to a master franchisee holding that ICC panels do not constitute proper §1782 tribunals. For franchisors anticipating matters in Asia and India, no §1782 cases have scrutinized whether the Hong Kong International Arbitration Centre (HKIAC) or the Singapore International Arbitration Centre (SIAC) function as foreign tribunals under the statute.

Depending on the institution selected, a foreign franchisor or a master franchisee occupying the same position as the one in Operadora may have an interest in augmenting the arbitration clause to specify that the arbitral award may be reviewed for limited purposes (e.g., procedural irregularities, jurisdictional issues, failure to accord due process). The International Centre for Dispute Resolution (ICDR)—the international affiliate of the American Arbitration Association (AAA)—permits the parties to agree to an option


111. Arbitration Act 1996, c. 23, §69 (Eng.).

112. Id. §69. The LMAA cautions, however, that such challenges are rarely made. Appeals based on de novo questions of law are rarely taken, and even when leave appeal is granted, a substantial proportion of awards are upheld. London Maritime Arbitrators Ass’n, Appeals, Challenges and Precedents, available at http://lmaa.org.uk/appeals-challenges-precedents.aspx (last visited Aug. 8, 2019).

113. Trachtenberg, supra note 1.

of appellate review.\textsuperscript{115} Bear in mind that the party on the other side of the transaction may be less likely to trade finality of the award and substantial cost of appeal to increase the chance of satisfying the functionality test for purposes of securing § 1782 assistance.

For the franchisor, master franchisee, or developer filing a petition or \textit{ex parte} application to take discovery under § 1782, consider making the “plain meaning” argument that the term “tribunal” in § 1782 includes private contractual arbitrations and is not ambiguous.\textsuperscript{116} In arriving at the contrary conclusion, the \textit{NBC} court considered court cases, international treaties, congressional statements, academic writings, and commentaries to conclude the statute did not plainly include or exclude private arbitral bodies.\textsuperscript{117} Subsequent decisions adopted \textit{NBC}’s reasoning.\textsuperscript{118} Notably absent from it was consideration of other national arbitration statutes, where references to “arbitral tribunal[s]” are commonplace.\textsuperscript{119} With the proliferation of arbitration statutes from other countries that use the same word, there may be merit to the notion that the practical, ordinary meaning of tribunal has changed since § 1782 was revised in 1964.\textsuperscript{120}

In addition, the district court receiving the request can be critical. Federal district courts in Connecticut,\textsuperscript{121} Delaware,\textsuperscript{122} Georgia,\textsuperscript{123} Massachusetts,\textsuperscript{124} Minnesota,\textsuperscript{125} and New Jersey,\textsuperscript{126} and most recently the Sixth Circuit,\textsuperscript{127} have considered private international arbitrations as either per se “tribunals” or meeting the Supreme Court’s functionality test. However, courts

\begin{footnotesize}
\begin{enumerate}
\item Tractenberg, \textit{supra} note 1, at 454.
\item The recent \textit{FedEx Corp.} decision takes perhaps the most comprehensive approach to this argument in its consideration of use of the word “tribunal” in legal and English dictionaries, legal writing around the time § 1782 was amended in 1964, and other uses of the word “tribunal” in the statute. \textit{See FedEx Corp.}, 939 F.3d at 719–23.
\item \textit{NBC}, 165 F.3d at 188.
\item See, \textit{e.g.}, Republic of Kazakhstan \textit{v.} Biedermann Int’l, 168 F.3d 880, 881 (5th Cir. 1999); \textit{Operadora}, 2009 WL 2433138, at *9 (“For the reasons articulated in \textit{NBC}, the Court finds that the term “foreign or international tribunal” is sufficiently broad that it could include private arbitral proceedings, but is not sufficiently precise to dictate such a conclusion.”).
\item Born, \textit{supra} note 11 at n.424 (citing UNCITRAL Model Law Chapters III, IV; English Arbitration Act, 1996, § 15; Swiss Law on Private International Law, Art. 176 \textit{et seq.}).
\item The Fifth Circuit described international commercial arbitration as a “then-novel arena” at the time of § 1782’s expansion. \textit{Biedermann}, 163 F.3d at 882.
\item \textit{In re Hallmark Capital Corp.}, 534 F. Supp. 2d 951 (D. Minn. 2007).
\item \textit{Abdul Latif Jameel Transp. Co. \textit{v.} FedEx Corp.}, 939 F.3d 710 (6th Cir. 2019).
\end{enumerate}
\end{footnotesize}
in California, Kansas, Indiana, Colorado, South Carolina, Texas, and the Northern Mariana Islands have not shown willingness to give such aid. Illinois, Florida and New York have gone both ways. The application itself should stress the availability and scope of judicial review in the foreign jurisdiction.

Finally, if the facts of a particular franchise dispute suggest the potential for other civil, criminal, or administrative proceedings before a foreign government, such as international corruption, collusion, or antitrust laws, consider Intel’s mandate that the foreign proceeding need not be “pending” or “imminent” but merely “within reasonable contemplation.” These circumstances may obviate the need to make the “foreign tribunal” argument in jurisdictions where the district court has a history of denying § 1782 applications in support of discovery for private arbitrations. The Eleventh Circuit employed this analysis in Consorcio II to affirm § 1782 discovery on grounds that were unrelated to whether private arbitral body was a foreign tribunal.

VIII. Conclusion

“Two words from a law review article” in the Supreme Court’s sole opinion on § 1782 continue to spawn disharmony in the courts fifteen years later, against the backdrop of increasing use of private international arbitration. Although resolution of a new circuit split would benefit franchisors, master franchisees, developers, and other businesses with a propensity to

137. See supra Part V.C.
139. See supra Part V.B.
enter into international arbitration agreements, available means remain to enable §1782 applications to be useful to foreign litigants rather than futile, while staying in tune the “twin aims” of the statute.
Creating Consistency: The Supreme Court’s Decision in Mission Products Holding, Inc. v. Tempnology, LLC

Travis Powers & Caitlin Conklin

I. Introduction

On May 20, 2019, the United States Supreme Court issued its decision in Mission Product Holdings, Inc. v. Tempnology, LLC, n/k/a Old Cold LLC,\(^1\) sending a ripple throughout the restructuring and franchising communities. The Court in Tempnology settled a split between the Seventh and First Circuits regarding the effect of a licensor’s rejection in bankruptcy of a license agreement under 11 U.S.C. § 365.

Specifically, the Court faced the following question: Does a debtor/licensor’s rejection of a trademark license agreement act as a breach of the agreement, or does the rejection acted as a full-scale rescission of the agreement? The answer to this question is of paramount importance because, on the one hand, if the Court determined it was a breach of the agreement, the non-debtor/licensee could assert a claim for damages in the licensor’s bankruptcy case while continuing to enjoy the benefits granted it under the license agreement. On the other hand, if the rejection is a rescission of the agreement, the licensee could assert a claim, but would be prohibited from further use of the trademarks. In an opinion written by Justice Elana Kagan, the most active questioner at the oral argument, the Court held that the rejection under §365 constitutes a breach of an executory contract by the debtor.

Following the Introduction in Part I, Part II of this article lays out the facts of Tempnology. Part III provides an overview of Bankruptcy Code §365.

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Part IV examines the Seventh Circuit’s finding that rejection of a license agreement acts merely as a breach of the agreement, entitling the licensee to assert a claim for damages in the licensor’s bankruptcy case while still enjoying the benefits granted under the subject agreement. Part V of this article examines the First Circuit’s holding that rejection of a license agreement terminates the licensee’s rights and interests thereunder. Finally, Part VI completes this article with an examination of the Supreme Court’s decision in Tempnology and its ramifications on parties to franchise and license agreements.

II. Facts of Tempnology

In 2012, Tempnology, LLC, a clothing and accessory manufacturer, entered into a license agreement (the Tempnology License Agreement) with Mission Holdings, Inc. (Mission). Under the Tempnology License Agreement, Mission was granted a license to distribute, on a global basis, certain products utilizing Tempnology’s proprietary “Coolcore” trademark. In September 2015, Tempnology filed for bankruptcy protection under Chapter 11. Subsequently, Tempnology attempted to use its bankruptcy filing to reject the Tempnology License Agreement. After rejecting the Tempnology License Agreement, Tempnology sought a declaratory judgment that such rejection terminated the agreement, thus depriving Mission from further use of the Coolcore marks.

The United States Bankruptcy Court for the District of New Hampshire (Bankruptcy Court) held that termination of the Tempnology License Agreement revoked Mission’s rights to use the Coolcore marks. On appeal, the Bankruptcy Appellate Panel for the First Circuit (1st BAP) reversed the Bankruptcy Court, finding that rejection of the Tempnology License Agreement acted merely as a breach, entitling Mission to a claim for damages and continued use of the Coolcore marks. The First Circuit reversed again, finding in favor of Tempnology, and an appeal to the Supreme Court followed.

III. Bankruptcy Code Section 365

Generally, Bankruptcy Code section 365 allows a bankruptcy trustee, or debtor-in-possession in a Chapter 11 case, to assume or reject certain “executory” contracts or “unexpired” leases of the debtor. Though neither of these terms is defined by the Bankruptcy Code, an unexpired lease is exactly that: a lease that has not expired pursuant to its own terms prior to a debtor’s

2. “Coolcore” refers to clothing and accessories designed to stay cool when used in exercise.
5. In re Tempnology LLC, 879 F.3d 389 (1st Cir. 2018) [hereinafter referred to as Tempnology II].
The Supreme Court's Decision in Mission Products Holding, Inc. v. Tempnology, LLC.

The filing of a bankruptcy case. An executory contract, by contrast, is widely defined as “a contract under which the obligation of both the bankrupt and the other party to the contract are so far unperformed that the failure of either to complete performance would constitute a material breach excusing the performance of the other.”

The purpose behind section 365 is to “allow a trustee or debtor in possession to eliminate burdensome, unprofitable contracts and preserve for the estate's benefit valuable agreements.” In determining whether to allow a debtor either to assume or to reject an executory contract or unexpired lease, courts rely on the debtor's business judgment and presume that the debtor “acted prudently, on an informed basis, in good faith, and in the honest belief that the action taken was in the best interests of the bankruptcy estate.”

In exercising of its business judgment in rejecting an executory contract, a debtor must show, at minimum, that rejection of the contract will provide a benefit to, or eliminate burdensome obligations on, the debtor's bankruptcy estate. Furthermore, a debtor seeking rejection of an executory contract must show that such rejection would inure to the benefit of general unsecured creditors rather than to a third party.

Of particular importance to the controversy that confronted the Supreme Court in Tempnology are Bankruptcy Code sections 365(g) and 365(n). Section 365(g) notes that rejection of an executory contract or unexpired lease “constitutes a breach of such contract or lease,” effective on the day preceding the debtor's bankruptcy filing. As rejection of an executory contract constitutes a prepetition breach, claims against the debtor arising from such rejection and breach are deemed general unsecured claims.
Bankruptcy Code section 365(n) applies to the assumption or rejection of certain agreements under which the debtor is a licensor of a right to “intellectual property.” This section provides a statutory right for the licensee to retain its rights to use the debtor/licensor’s patent or copyright. Generally, in exchange, the licensee must continue to perform its obligations under the license, that is, paying royalties.

Section 365(n) was enacted as a direct congressional response to the Fourth Circuit’s 1985 decision in *Lubrizol Enterprises, Inc. v. Richmond Metal Finishers, Inc.*, in which the court held that the rejection of an intellectual property license agreement stripped the non-debtor/licensee’s ability to continue use of any copyrights, trademarks, or patents granted from the debtor/licensor. Three years following *Lubrizol*, Congress enacted Bankruptcy Code section 365(n) to allow licensees to continue using certain intellectual property even though the subject agreement granting rights in such property had been properly rejected under Bankruptcy Code section 365(a).

At first blush, it would appear that the Supreme Court’s determination in *Tempnology* would begin and end with an analysis of section 365(n). But it is important to note that, although the Bankruptcy Code defines “intellectual property,” it does so without mention to trademarks such as those at issue in *Tempnology*. Indeed, the Bankruptcy Code defines “intellectual property” to mean only (i) trade secrets; (ii) inventions, processes, designs, or plants protected under federal patent law; (iii) patent applications; (iv) plant varieties; (v) works of authorship protected under federal copyright law; and (vi) mask work protected under federal semiconductor chip law. Pursuant to Bankruptcy Code section 365(n), if a debtor/licensor rejects an executory contract under which the debtor has licensed the rights to “intellectual property,” the licensee thereunder may exercise one of two options: (i) the licensee may treat such contract as terminated, or (ii) the licensee may retain its rights, and attendant obligations, under the subject contract as they existed immediately prior to the debtor’s bankruptcy filing (including continued use of the subject intellectual property) for the duration of the contracts original term. Therefore, section 365(n), by its express terms, does not cover trademark licenses. Because of this, as discussed below, courts have differed on the effect of rejection on a licensee’s rights to use trademarks.

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15. 11 U.S.C. § 365(n); see also *In re CellNet Data Sys., Inc.*, 327 F.3d 242, 250 (3d Cir. 2003).
17. *Id.*, at 1048; *see also Sunbeam Prods., Inc. v. Chicago Am. Mfg., LLC*, 686 F.3d 372, 375 (7th Cir. 2012).
18. *Sunbeam*, 686 F.3d at 375.
20. *Id.*
21. *Id.* § 365(n).
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IV. The Seventh Circuit View—Rejection of a License Agreement Equals Mere Breach

In *Sunbeam Products, Inc. v. Chicago American Manufacturing, LLC*, the Seventh Circuit was tasked with deciding a case nearly identical to *Tempnology*.22 Lakewood Engineering & Manufacturing Co. (Lakewood) manufactured and sold certain consumer products covered by various patents and trademarks (Lakewood Marks).23 Facing financial difficulty, Lakewood entered into a license agreement (Lakewood Agreement) with Chicago American Manufacturing, LLC (CAM), under which CAM would produce approximately 1.2 million box fans during the 2009 season, using the Lakewood Marks, and ship the fans to third-party retailers who placed orders through Lakewood.24 To induce CAM into making the financial investment required to produce over 1 million box fans without assurances of payment, Lakewood authorized CAM to sell any previously unsold box fans on its own account to recoup any losses CAM may endure.25

After an involuntary Chapter 7 petition was filed against Lakewood, the court-appointed Chapter 7 trustee sold Lakewood’s business operations to Sunbeam Products, Inc. (Sunbeam) and subsequently rejected the Lakewood Agreement between Lakewood and CAM.26 In an effort to prohibit CAM from continuing to produce and sell box fans bearing the Lakewood Marks, as agreed to under the Lakewood Agreement, Sunbeam commenced an adversary proceeding.27 The Bankruptcy Court, basing its decision on equitable grounds, held that, despite rejection, CAM was entitled to produce and sell as many box fans as Lakewood had previously estimated was necessary for the 2009 season, and to sell the fans bearing the Lakewood Marks.28 Sunbeam appealed the lower court’s decision, and that appeal was certified directly to the Seventh Circuit.29

The Seventh Circuit faulted the Bankruptcy Court’s reliance on “equitable grounds” because “[w]hat the Bankruptcy Code provides, a judge cannot override by declaring that enforcement would be ‘inequitable,’” but found that such reliance “does not necessarily require reversal.”30 The Seventh Circuit explained that, outside bankruptcy, a licensor’s breach does not terminate a licensee’s rights. In fact, state law provides a number of licensee remedies short of termination. As such, the Seventh Circuit explained, “Lakewood could not have ended CAM’s right to sell the box fans by failing to perform its own duties, any more than a borrower could end the lender’s

22. *Sunbeam*, 686 F.3d at 375.
23. *Id.* at 374.
24. *Id.*
25. *Id.*
26. *Id.*
27. *Id.*
28. *Id.* at 375.
29. *Id.*
30. *Id.*
right to collect just by declaring that the debt will not be paid.” 31 Indeed, as
the court further noted, by classifying rejection of an executory contract as
a breach, Bankruptcy Code section 365(g) establishes that the non-debtor’s
rights under the subject contract remain in place just as they would outside
of bankruptcy.32

Therefore, the Seventh Circuit held that the rejection of a trademark
license agreement does not rescind the licensee’s right to use the trademarks.
Rather, rejection merely operates as a breach of the license agreement, enti-
ting the non-debtor party to retain its rights thereunder and a claim for
damages arising from the debtor’s unfulfilled obligations.

V. The First Circuit View—Rejection of a
License Agreement Equals Rescission

The First Circuit, in In re Tempnology LLC, reversed the decision of the
lower court, explicitly rejecting the ruling set forth by the Seventh Circuit in
Sunbeam.33 In doing so, the First Circuit determined that, because they are
not enumerated in the Bankruptcy Code’s definition of “intellectual prop-
erty,” trademarks are not protected under Bankruptcy Code section 365(n).34
Furthermore, the court reasoned, an exclusivity clause in a license agreement
does not bring distribution rights in the purview of the protections afforded
under section 365(n).35

When considering whether Mission retained its rights to use Temp-
ology’s trademark post-rejection, the court noted that, “[i]n defining the
intellectual property eligible for the protection of section 365(n), Congress
expressly listed six kinds of intellectual property. Trademark licenses (hardly
something one would forget about) are not listed, even though relatively
obscure property such as ‘mask work protected under chapter 9 of title 17’
is included.”36

Furthermore, the court explained that allowing a non-debtor to continue
use of a rejecting debtor’s trademark would require the debtor, as trademark
owner, to continue to monitor and exercise control over the quality of trade-
marked goods offered to the public.37 Thus, the First Circuit concluded that
the holding in Sunbeam

[w]ould allow Mission to retain the use of Debtor’s trademarks in a manner that
would force Debtor to choose between performing executory obligations arising
from the continuance of the license or risking the permanent loss of its trade-
marks, thereby diminishing their value to Debtor . . . . Such a restriction on
Debtor’s ability to free itself from its executory obligations, even if limited to

31. Id.
32. Id. at 377.
34. Id. at 401.
35. Id. at 398.
36. Id. at 401 (quoting 11 U.S.C. § 101(35A)) (internal citations omitted).
37. Id. at 402.
trademark licenses alone, would depart from the manner in which section 365(a) otherwise operates.\textsuperscript{38}

The court’s decision created a clear circuit split on whether the rejection of a license agreement would preclude trademark licensees, including franchisees, from continuing to use the trademark following a bankruptcy rejection.

\textbf{VI. The Supreme Court and Tempnology}

The First Circuit case, on appeal to the Supreme Court, raised two critical legal questions: (1) whether the case was moot because the trademark license had expired; and (2) whether the Debtor’s rejection of its contract with Mission resulted in rescission of Mission’s license to use the Debtor’s trademarks, contrary to the Seventh Circuit’s holding in \textit{Sunbeam}.\textsuperscript{39}

The Court resolved the mootness issue in favor of Mission, stating that the suit would remain live as long as there is any chance of money exchanging hands.\textsuperscript{40} The Court explained that “Mission has presented a claim for money damages—essentially lost profits—arising from its inability to use the Coolcore trademarks between the time Tempnology rejected the licensing agreement and its scheduled expiration date”\textsuperscript{41} and that, “[f]or better or worse, nothing so shows a continuing stake in a dispute’s outcome as a demand for dollars and cents.”\textsuperscript{42}

As to the second question, relying on statutory interpretation, the Court noted the two competing views of the First and Seventh Circuits and firmly sided with the Seventh Circuit’s \textit{Sunbeam} decision, finding that Bankruptcy Code section 365(g) clearly states that rejection of a license or other executory contract “breaches a contract but does not rescind it” and that “all the rights that would ordinarily survive a contract breach . . . remain in place.”\textsuperscript{43} That breach is deemed to have occurred immediately before the filing of the bankruptcy case. The Court held that, under the plain language of section 365(g), “rejection of an executory contract or unexpired lease of the debtor constitutes a breach of such contract or lease” to mean that “rejection breaches a contract but does not rescind it” and, therefore, that “all the rights that would ordinarily survive a contract breach, including those conveyed here, remain in place.”\textsuperscript{44} Although section 365 allows a debtor to reject burdensome contracts, it “does not grant the debtor an exemption from all the burdens that generally applicable law—whether involving contracts or trademarks—impose on property owners.”\textsuperscript{45}

\textsuperscript{38}. \textit{Id.} at 403.
\textsuperscript{40}. \textit{Id.} at 1660.
\textsuperscript{41}. \textit{Id.}
\textsuperscript{42}. \textit{Id.}
\textsuperscript{43}. \textit{Id.} (“Today, we hold that both Section 365’s text and fundamental principles of bankruptcy law command the first, rejection-as-breach approach.”).
\textsuperscript{44}. \textit{Id.} at 1658–69.
\textsuperscript{45}. \textit{Id.}
If a debtor rejects a license agreement, “the debtor can stop performing its remaining obligations under the agreement. But the debtor cannot rescind the license already conveyed. So the licensee can continue to do whatever the license authorizes.”46 The Court wrote that, “[i]n preserving those rights, Section 365 reflects a general bankruptcy rule: The estate cannot possess anything more than the debtor itself did outside of bankruptcy.”47

Central to the Court’s holding was that a debtor should not be allowed to use its breach of a contract as a tool to deny the counter-party its rights under said contract. To illustrate this point, the Court set forth a hypothetical fact scenario involving a copy machine lease to a law firm.

A dealer leases a photocopier to a law firm, while agreeing to service it every month; in exchange, the firm commits to pay a monthly fee. During the lease term, the dealer decides to stop servicing the machine, thus breaching the agreement in a material way. The law firm now has a choice (assuming no special contract term or state law). The firm can keep up its side of the bargain, continuing to pay for use of the copier, while suing the dealer for damages from the service breach. Or the firm can call the whole deal off, halting its own payments and returning the copier, while suing for any damages incurred.48

The decision of whether to terminate the agreement and return the copier is for the law firm to make. In fact, the dealer would be in no position to terminate the agreement and reclaim the copy machine. The Court reasoned that, similarly, should the dealer be a Chapter 11 debtor, the dealer/debtor should not be able to use section 365 to terminate the lease and to reclaim the copier.49 The Court stated that to determine otherwise would be to grant the debtor with avoidance powers, which are not set forth in the Bankruptcy Code and “would subvert everything the Code does to keep avoidances cabined.”50

The Court addressed and rejected Tempnology’s arguments that there was a “negative implication” created by other provisions in Bankruptcy Code section 365, such as sections 365(h) and 365(n).

Several provisions of Section 365, Tempnology notes, ‘identify[] categories of contracts under which a counterparty’ may retain specified contract rights ‘notwithstanding rejection.’ . . . Sections 365(h) and (i) make clear that certain purchasers and lessees of real property and timeshare interests can continue to exercise rights after a debtor has rejected the lease or sales contract. . . . And Section 365(n) similarly provides that licensees of some intellectual property—but not trademarks—retain contractual rights after rejection.51

The Court summarized Tempnology’s argument by writing, “Tempnology argues from those provisions that the ordinary consequence of rejection must be something different—i.e., the termination, rather than survival, of

46. Id.
47. Id.
48. Id. at 1662.
49. Id.
50. Id.
51. Id. at 1663.
contractual rights previously granted.”52 Then the Court immediately dismissed Tempnology’s argument that Congress, by failing to include trademarks within the language of Section 365(n), had intended a different outcome for trademark licenses by saying that the “argument pays too little heed to the main provisions governing rejection and too much to subsidiary ones.”53

The Court emphasized that its ruling was consistent with the relevant policy considerations and with balancing the needs of a reorganizing debtor against those of a contractual counter-party.54 “The Code of course aims to make reorganizations possible. But it does not permit anything and everything that might advance that goal.”55 The Court concluded its decision by noting that “[t]he resulting balance may indeed impede some reorganizations, of trademark licensors and others.”56

Importantly, in her concurring opinion, Justice Sotomayor wrote that “the Court does not decide that every trademark licensee has the unfettered right to continue using licensed marks postrejection . . . But the baseline inquiry remains whether the licensee’s rights would survive a breach under applicable nonbankruptcy law.”57 What Justice Sotomayor so aptly points out is that the Court is leaving open for later litigation what rights a trademark licensee may retain, along with the licensee’s ability to protect those rights.

VII. Conclusion

While the Court’s decision in Tempnology was specific to a “license” agreement, many franchise agreements are similarly structured in that a franchisee is granted authority to operate its business utilizing the franchisor’s marks and systems that, many times, are immediately identifiable to the general public. Whether it be a hotel, fast food, corporate format, investment, or conversion franchise, the Court’s decision opens the door for franchisees to continue to operate using these marks and systems despite a bankruptcy franchisor’s rejection of the operative franchise agreement. At a minimum, licensors and franchisors must be keenly aware of the language incorporated into the operative agreement, specifically with regard to identifying with particularity the remedies of both parties following rejection under the Bankruptcy Code.

Going forward, both licensors/franchisors and licensees/franchisees (and their counsel) must be mindful of the Court’s decision in Tempnology. Even if a license or franchise agreement survives after rejection and breach, the debtor/licensor or franchisor likely will have nullified any duties it had to take action under the operative agreement. The debtor/licensor or franchisor

52. Id.
53. Id. at 1664.
54. Id.
55. Id. at 1665.
56. Id. at 1666.
57. Id. at 1666 (Sotomayor, J., concurring).
may decide no longer to maintain the trademark registration, or the overall quality of the subject mark may diminish. So there remain many unanswered questions about how the process may play out. Both parties to a license agreement would be wise to have a full understanding of their basic contract rights under state law, as its application remains steadfast in the bankruptcy process.
Fashion and Luxury Product Franchising in the European Digital Landscape

Martine de Koning

This article will highlight some of the most pressing developments in the online sale of fashion and luxury products, both in Europe and globally. With new technologies and increasingly digital markets, consumers desire and expect the best buying experience. Consumers travel, and online business is by its nature international. Online purchasing is faster than in the real world, which has a material effect on how businesses operate. It is even disruptive in the sense that aptitude in digital commerce may define success or failure in the fashion industry.

To build and maintain an exclusive brand image, brand owners spend large budgets on advertising, marketing, and events, and consumers are the focal point of these efforts. To stay relevant as a brand, it is critical for a company to continually learn about consumer preferences, which is often accomplished through the collection and analysis of transaction data and consumer profiles. Products and services need to be tailored to what the consumer wants, when and where he or she wants it. To stay competitive, a brand’s products and service offerings should exude a uniform brand image. Further, brands need to be aligned in image and vision across multiple online and offline sales channels.

Traditional methods of selling fashion and luxury products via brick and mortar multi-brand retailers are at risk of becoming less effective, unless there is alignment with the digital footprint of the brand and the online activities of all of a brand’s retailers. Most brands invest in direct-to-consumer sales on their own websites and in mono-brand stores, including flagship stores. Digital loyalty programs play an important role, with mobile apps designed to support brand loyalty. Targeted advertising gives the consumer precise information on what catches his personal interest, by sending push marketing messages to encourage and influence purchase decisions (e.g. by using cookies, ambient intelligence, dynamic pricing, pricing algorithms to follow competitor pricing, etc.).

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Most European fashion and luxury brands operate mono-brand stores to showcase the brand’s vision and products. These stores can be owned or be part of a mono-brand store network through the licensing of the trademark, a retail concept, and the brand-owner’s expertise. Even though many fashion brand owners typically do not charge a franchise fee, many of these relationships may qualify as franchise agreements under national laws in Europe.

This article focuses on the integration of online and traditional offline channels, so-called omni-channels. The positioning of the brand, and maintaining its premium, high-end, luxury image, is key to continued success in the market. This requires a certain degree of control over all points of contact with the consumer. Where these points of contact are owned by the brand, this is a matter of developing a strategy and implementing it within the company. Where these points of contact are not owned, and depending on the contracts at issue, the brand may require the retailer’s support, which can be challenging to obtain. It may even require the modernization of traditional profit models. And the European regulatory framework provides even larger challenges. In principle, brand owners cannot prohibit internet sales by licensed retailers, so reserving the online channel for the brand alone is not an option. Vertical price fixing is also, in principle, prohibited, and, therefore, retailers must be free to determine their own prices. Further, the data protection and e-Privacy rules in the EU are among the strictest in the world.¹

All of this means that brand owners must intensively cooperate with independent retailers, brick and mortar outlets, and pure players on events, loyalty programs, promotions, ambient intelligence and targeted advertising. This includes increased data sharing, such as consumer information and pricing data, sensitive issues under both competition and data protection laws. With this increased cooperation comes a focus on direct sales to consumers, both offline and online. Suppliers are thus more directly impacted by consumer laws and consumer data and privacy protection rules than before. Several legal developments affect the regulatory environment, such as the European Union directives on e-commerce, and unfair consumer contracts (“a new deal for consumers”), and the regulation on geo-blocking.²


The importance of Internet platforms remains undeniable. Some regulators in the European Union, such as the European Commission and the German Bundeskartellamt, have launched investigations into, for example, the search engine Google, and the use of (transaction) data by Internet platforms such as Amazon. A proposed regulation that aims to ensure transparency, including showing one's own services in ranking above third-party services on search engine results, and adequate dispute resolution, may protect small and medium-sized enterprises from unfair contract clauses. But is increasing the already dense level of regulation and enforcement action in the European Union really necessary? And, if so, will the industry even benefit from creating a “level playing field”?

All of this background demonstrates that the regulatory environment is dense and difficult to parse. This article will explore many of these issues. It will first focus on the legal implications for (luxury) fashion industry that wishes to ban third-party platforms. Second, it will discuss the heart of omni-channel. Third, the article will discuss recent changes in fashion franchising. Fourth, the author will outline the role of influencers and social media in the industry. Finally, the article will conclude with some notes on velocity in fashion.

I. Internet Sales and Third-Party Platform Restrictions

The European Union is one of the world’s largest e-commerce markets. In 2017, online revenues of retailers were already 19.5% higher than they were in 2016. The effect of the digital world is now so pervasive that virtually all aspects of economic and social life have a digital dimension. According to European lawmakers, this shift towards a digital economy calls for new legal frameworks. Since May 2015, the European Union has had on its
agenda a Digital Single Market Strategy with about twenty-three legislative proposals which are designed to, among others, create better access for business and consumers to online goods, services, and content.\(^7\)

According to the e-commerce sector inquiry findings of the European Commission, e-commerce boosts the economy in the European Union.\(^8\) It generally creates increased competition due to more price transparency.\(^9\) Restrictions, such as Internet sales by retailers and vertical price fixing, are frowned upon by EU lawmakers and courts. As a result, to maintain some control over the brand positioning and to avoid free riding by retailers that do not invest in quality and service, brand owners increasingly feel the need to protect the luxury image of their products, and to keep control over the quality of their goods and service delivery, through methods such as selective distribution.\(^10\) Selective distribution limits the distribution of products to authorized retailers and end users, thus creating a trusted and closed system of retailers representing the brand. Many brand owners prohibit sales by the retailer through all or certain third-party Internet platforms, because they consider these platforms to be more meeting/trading places rather than a quality-controlled sales environment that is aligned with the brand’s vision and image.

In *Pierre Fabre*,\(^11\) the Court of Justice of the European Union (CJEU) ruled that an absolute ban on online sales, whether direct or indirectly applied, is a hardcore restriction and thus prohibited under EU competition law, specifically the cartel prohibition laid down in Article 101(1) of the Treaty on the Functioning of the European Union (TFEU). Hardcore restrictions are defined in Article 4 of the Vertical Block Exemption Regulation (VBER),\(^12\) which relates to vertical restraints, and are typically prohibited as violations of EU competition law. An example of a hardcore restriction is resale price maintenance.

But many vertical restrictions, except hardcore restrictions, can benefit from the safe haven provided by the VBER applicable to vertical restraints.\(^13\) While Internet sales may not be prohibited,\(^14\) qualitative criteria to website’s retailers are permitted.\(^15\) Through a clause in the Dutch Competition Act,


\(^9\) Id. at 5.

\(^10\) de Koning & De Vries, supra note 1, at 5–6.


\(^13\) Id.

\(^14\) Pierre Fabre Dermo-Cosmétique, ECJ (2011); see also 2010 O.J. (C 130/01) Commission Guidelines C 130/01 of May. 19 2010 on Vertical Restraints [hereinafter Commission Guidelines].

\(^15\) *Vertical Block Exemption Regulation*, supra note 12; Commission Guidelines, supra note 14.
the rules of the block exemption also apply to trade in the Netherlands that has no cross-border effect. It is important to note that including a hardcore restriction in a contract leaves the entire contract without the safe harbor of the block exemption.

The CJEU took a more nuanced approach in its December 6, 2017, judgment in Coty/Akzente. Coty, a provider of luxury cosmetics in Germany, asked whether Coty could legitimately prohibit its retailer, Parfümerie Akzente, from selling the brand’s products via amazon.de. German courts came to different conclusions on the topic of Internet platforms restrictions. Some, but not all German civil courts, and the Bundeskartellamt (Bka) found these restrictions anticompetitive. This has led to a request by the higher regional court in Frankfurt for a preliminary ruling of the CJEU on the interpretation on several points of EU law. In response to these prejudicial questions, the CJEU followed the conclusion of Advocate-General Wahl, the opinion of the European Commission, and several Member States (including the Netherlands), except for Germany and Luxembourg. In short, the CJEU confirmed that a selective distribution system for luxury goods designed, primarily, to preserve the luxury image of those goods, is not incompatible with TFEU Article 101(1), provided that resellers are chosen on the basis of objective criteria of a qualitative nature, which are laid down uniformly for all potential resellers, are not applied in a discriminatory manner, and do not go beyond what is necessary. In this context, a clause prohibiting distributors from making use of non-authorized third-party platforms, does not constitute a hardcore restriction under VBER Article 4(b) or 4(c).

16. Art. 12 BW.
18. In earlier cases, some higher regional courts accepted bans on sales via third-party platforms, such as in the Karlsruhe and Munich Courts of Appeals (decisions 6 U 47/08 Kart of 25 November 2009, and U (K) 482/08 of 2 July 2009, respectively), and in 2015 the Frankfurt Court of Appeal (decision 11 U 84/14 Kart of 22 December 2015). The products at issue were schoolbags and sport items. Recently, the Hamburg Court of Appeal (decision 3 U 250/16 of 22 March 2018) ruled over the lower court decision that a manufacturer of non-luxury but high-quality food supplements and various toiletries may prohibit distributors from selling its goods over third-party platforms. In some cases, including BKa decisions (for example Sennheiser B7-1/12-35 of 24 October 2013 and Adidas B3-137/12 of 27 June 2014), a ban on sales via third-party platforms was deemed incompatible with the cartel prohibition.
19. See, Request for a preliminary ruling from the Oberlandesgericht Frankfurt am Main (Germany) lodged on 25 April 2016—Coty Germany GmbH v Parfümerie Akzente GmbH.
20. See id., ¶ 20.
The judgment was welcomed by brand owners and suppliers of fashion and luxury products in Europe. In July 2018, the higher regional court in Frankfurt affirmed that perfume maker Coty was within its rights when it prohibited one of its traders from selling its products over Internet platforms.25

Two categories of products justify a selective distribution system in order to preserve quality and ensure their proper use: (1) technically complex products; and (2) luxury (or branded) products.26 A Dutch court had already reached the same conclusion.27 Selective distribution of other products may be block exempted if the market share of both parties is below 30%, and the agreement does not contain hardcore restrictions.28 If these conditions are not met, an individual exemption may still apply.29 In July 2018, the Court of Appeal in Paris ruled that a supplier at the head of a selective distribution network can legitimately prohibit the sale of its products in a marketplace.30

The decision arises from a dispute between Caudalie, a manufacturer of luxury cosmetics, and the third-party platform “1001 pharmacies” owned by eNova Santé.31 Immediately after the CJEU ruling, the German Competition Authority held that brand manufacturers do not have carte blanche to issue online marketplace bans.32

The European Commission is crystal clear in its interpretation of the Coty judgment: “[M]arket place bans do not amount to a hardcore restriction under the VBER irrespective of the product category concerned.”33 The French competition authority more recently followed this interpretation.34 The sale of Stihl products, such as chainsaws, brush cutters, and pole-saws, justified a selective distribution system, which included assistance and consultancy services, to preserve their quality and ensure proper use.35 It is further permissible for a system to include a third-party platform restriction

25. Oberlandesgericht Frankfurt am Main, judgment (July 12, 2018), Az. 11 U 96/14 (Kart); see also Press Release, Luxusprodukte rechtfertigen Vertriebsverbot auf Amazon.de [Luxury products justify sales ban on Amazon.de], https://ordentliche-gerichtsbarkeit.hessen.de/pressemitteilungen/luxusprodukte-rechtfertigen-vertriebsverbot-auf-amazone.de.
28. Vertical Block Exemption Regulation, supra note 12, Art. 3.
31. Id.; Cour de cassation (Sept. 13, 2017) (Caudalie/eNova), 16-15067.
35. Id.
to protect the brand image. Stihl demanded hand-delivery of this type of product by the distributor to the buyer, and therefore the court concluded that imposing a collection from the dealer, or a delivery to the home of the buyer, disproportionately limited competition because hand delivery is not required by any national or European regulation concerning the marketing of the products in question. The latter ruling seems to grasp back to the Pierre Fabre ruling on indirectly limiting Internet sales of the retailer.

In sum, while there is clarity at EU level, in some jurisdictions the outcome still seems somewhat uncertain or even contradictory to the European Court’s and certainly the European Commission’s position. Agreements should be carefully crafted in the relevant economic and business context to ensure that the lawful protections are included, but not to overstep the legal boundaries in order to not violate competition laws.

II. Integrated Marketplace

Today customers use mobile devices, desktops, radio, television, and other channels to stay connected with the world around them. These are also the ways in which they hear about and purchase products and services. But each channel has unique demands for messaging and connecting with prospective clients. To survive, retailers today need to understand the relationships between all of their digital and physical channels and create a seamless, omni-channel brand experience. Delivering great omni-channel experiences builds trust for the brand, deepens brand loyalty, and increases the lifetime value of products in the view of customers.

People do not walk into a retail store to find their next look. They turn to their social media feeds to see what is happening around them with friends, or with people or brands they admire. Buyers expect highly personalized and consistent shopping experiences at every touchpoint. Whichever channel the customer uses, the experiences should be high quality and consistent among all channels. A smooth functioning of interconnected sales channels requires a tailored legal solution.

What are the risks and the profit models of the integrated marketplace as it exists today? The business can use terms like “click & collect,” “drop ship,” “buy online return in store,” or “inventory sharing” to promote cooperation between suppliers and retailers in serving the consumer when and where he or she wants it. But what are the legal implications, if any of these revised business models?

Let’s start with a simple click and collect example. The consumer orders online with the supplier on its website, but indicates that he or she wants to pick up the product in the nearest brick and mortar store. This happens to be a mono-brand store operated by an independent retailer under a license

36. Id.; see also Case C-230/16, Coty Germany GmbH v. Parfümerie Akzente GmbH, ECJ (2017).
37. Case T-234/01, Andreas Stihl AG & Co. KG.
from the supplier. The agreement between the retailer and the supplier therefore needs to include provisions ensuring that the retailer will (1) provide service to the consumer regarding any orders placed with the supplier by maintaining these products in inventory when dropped off by the supplier; (2) handle the consumer in the store; and (3) offer the products, along with any relevant product details or explanations, packaging, and payment, if that was not already taken care of online. This will cost the retailer time and money, and he or she will expect compensation, perhaps on either a fixed or variable service fee. Because this concerns aspects of the performance of the contract between the supplier and the consumer, but not the contract execution itself, it could be viewed as subcontracting or outsourcing certain tasks to the retailer. Under Dutch civil law for example, it would be an agreement of ‘assignment;’ in other words, services. While much of this is governed by statutory law, very few rules are mandatory, and it usually does not get very complex, provided that the retailer wants to engage in this model.

Slightly more complex, at least in the European Union, is the situation where the supplier asks the retailer to place a touchscreen in its store that allows the consumer to directly order products from the supplier’s website that the retailer does not have on display or in its inventory. The question arises whether this qualifies as commercial agency under the EU Directive on the coordination of the laws of the Member States relating to self-employed commercial agents (Commercial Agency Directive). As transposed into national laws in the EU member states, a commercial agent is a self-employed intermediary who has continuing authority to negotiate the sale or the purchase of goods on behalf of a principal and is remunerated therefor, or to negotiate and conclude such transactions on behalf of and in the name of that principal. But is offering a screen in a store really the same as providing intermediary services resulting in leads within the meaning of the Commercial Agency Directive as transposed into national laws in the various EU member states? If the Commercial Agency Directive is applicable, it contains a range of mandatory requirements, including ones focused on goodwill compensation, requirements that cannot be contracted away from by inserting a choice of forum for a foreign law. The risks of such an arrangement for the supplier may go well beyond its expectations. And the retailer may be surprised with the amount of pick-ups it has to facilitate or by the space that the products will take in its stockrooms if consumers are late in picking up their orders. Payment on the moment of pick up (rather than on the moment of making the purchase) may not be ideal for either party, because it will offer less incentive for consumers to actually speedily pick up what they ordered online. In the European Union, mandatory rules protect the right of the consumer to give back a product bought online for

38. Dutch Civil Code, art. 7:400 [hereinafter DCC].
reimbursement of the product price. Some exceptions apply, but few are relevant to the fashion and luxury products industry. The retailer may, therefore, also be asked to handle these product returns (in addition to defective products), which may add on to its required tasks.

To get products to the consumer when and where he or she wants it, warehousing and logistics are a critical factor. This includes the time that products spend in stockrooms of the distributor or retailer. In the past decade, a range of so called “inventory management” models has been developed. For example, in franchising networks, it was already common to use directed assortment and auto-replenishment programs that are aimed at assisting the retailer in offering products that best fit the target audience and location of the store. These programs will already reduce inventory, product leftover, and product returns, as well as increase efficiencies. Real time “inventory assist” apps are developed and offered both to consumers and to stores to assess if a product is in inventory with the retailer and, if not, to identify the closest place it is in stock or to buy it online.

Inventory sharing models go even a step further. Suppliers may assist retailers by placing product with the retailer without actually selling it. If sales are slower than expected in one location, the supplier can move to pick it up and place it elsewhere in the market where there is a higher demand for it. In this so-called “consignment stock” setup, the sale is made by the retailer, but the account and risk of the supplier are linked directly to the consumer. Title and ownership shift directly to the consumer. Variations occur, such as where the retailer acts in his own name or in the name of the supplier. Some of these structures may qualify as commercial agency, to which mandatory rules apply. In addition, there may be consequences under applicable tax laws (in particular but not limited to Value Added Tax (VAT)) shifting from a resale model to a consignment stock model. It is very important to carefully draft agreements that include clear roles and responsibilities, such as the risk and insurance of the products held in stock by the retailer for the supplier. Contract drafters must also describe in the agreement the precise responsibilities the retailer has to market and sell the stock, since it will have less incentives to make sales if it can just ask the supplier to pick up the product if the retailer cannot sell it. Some concept stores are so “high end” that new brands or brands slightly falling in popularity may not be able to negotiate immediate sales of the products, but

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44. Although beyond the scope of this article, we point to the importance of compliance with Turnover tax laws such as the Dutch Turnover Tax Act of 1968.
the stores will take their product for display in the store, without any further commitment regarding sales or marketing efforts.

III. Franchising of Fashion and Luxury Products

What are the specific do’s and don’ts for fashion franchisors and franchisees in digital commerce and omni-channel? Given the earlier referenced changes in the distribution models with independent retailers, franchise agreements for fashion and luxury products may need to be revised to reflect these changes and to clarify roles and responsibilities. In particular, profit-sharing models, the roles and responsibilities regarding the collection and processing of consumer data, and compliance with increased consumer protection laws will have to be dealt with in the franchise or mono-brand store agreements.

A. Exclusive Territories and Internet Sales

Other changes in store network management are also important. For example, in the digital context, it may no longer be a logical or viable choice to allocate exclusive territories to franchisees. This may vary by region, but given the regulatory setting in the European Union, a trend among franchisors of fashion and luxury products is to no longer allocate a radius around the mono-brand store to the franchisee, because the franchisee must endure competition online anyway. In the European Union, passive sales (including Internet sales) outside of an exclusive territory or customer group cannot be restricted.45 Active sales can be restricted, but only when the supplier has reserved the territory or customer group for himself or exclusively allocated to another distributor.46 Many suppliers of fashion and luxury products now rely on selective (rather than exclusive) distribution systems, part of which can be the franchise or license agreements with mono-brand store operators. In this situation, sales to retailers outside the system can be prohibited.47 Cross sales, such as those between authorized retailers, cannot be restricted, since it would entail market partitioning within the European Union, which is a prohibited restriction by object (cf. a per se restriction).48 The European Commission and some national authorities have intensified enforcement activities of vertical restraints in recent years and in the context of the e-commerce sector inquiry.49 In particular vertical price fixing, Internet sales restrictions, and restrictions on cross-border sales between EU member states have been

46. Id.
47. Id.
on the enforcement agenda over the last few years. So understanding and properly drafting territorial restrictions and limitations, or selective distribution policies and contracts, are critical.

B. E-commerce and Omni-channel

E-commerce and omni-channel have had a major impact on the retail landscape in general and franchise systems in Europe (as well as the wider EMEA region). For brand owners and suppliers, it is critical to improve their logistics to get the product to the consumer faster, where the consumer wants it.

A key question for franchisors worldwide is whether and, if so, how they can involve their franchisees in their online activities. As stated earlier, in the European Union it is not an option for most franchisors to fully control the online marketing and sales activities of their brands and franchise networks. Franchisees have the freedom to set up their own websites. As a result, there is a chance of conflict between franchisors and franchisees regarding e-commerce. The genesis of most of these conflicts is the franchisor’s website, if it competes directly with the franchisees. Franchisees often claim a share of the earnings made online by the franchisor. Some franchise disputes, such as in department store chains, concern the franchisor’s online offering of products or services with delivery service. Franchisees claim that this is a violation of their exclusive rights in an area or radius around their franchise store or that they otherwise should be rewarded in a more balanced way. Online orders made on the website of the franchisor can be picked up (and sometimes paid) by consumers in a physical store of the franchisee. Moreover, in luxurious fashion chains, it is now possible to order products online in the store, directly from the website of the franchisor (often if the physical store of the franchisee does not have the specific product in stock). At that moment, the franchisee is a “commercial agent” for the franchisor and can be paid a commission for this sale. To regain control over brand image, reputation, and pricing of products, some franchisors have implemented “genuine” agency models or commissionaire models to replace existing franchise networks in Europe. From the guidelines to the EU Vertical Block Exemption Regulation, it follows that certain types

50. See, e.g., European Commission Press Release, Antitrust: Commission Fines Four Consumer Electronics Manufacturers for Fixing Online Resale Prices (July 24, 2018), http://europa.eu/rapid/press-release. This decision is also interesting because pricing algorithms and price monitoring tools are mentioned in the discussion.

51. In the Netherlands department store chain Hema, beauty chain Kruidvat, and other franchisees are involved in disputes with their franchisor on the use of websites.

52. Martine De Koning & Hester De Vries, Wat is de Impact van de Algemene Verordening Gegevensbescherming van de EU op internationale franchiseovereenkomsten, 2018 CONTRACTEREN 1, 21 (2018).

of agency fall outside the cartel prohibition. This exemption applies if the agent is sufficiently integrated in the undertaking of the principal based on the fact that it bears all financial and commercial risks. In this situation, the agreement is a so-called “genuine” agency, and, if the agent acts in his own name, commissionaire. The supplier may then maintain the resale price and determine the other commercial and legal terms applied by the retailer towards his customers. The supplier may, in “genuine” agency or commissionaire situations, prohibit or keep for himself Internet sales. The agent or commissionaire bears no or only insignificant risks, and he earns a commission for intermediary services that he provides. Clearly, the retailer loses his status as an independent entrepreneur, because he sells for the account of the principal. This provides the supplier precisely the control over the brand and the interfacing with the consumer that it may find crucial to maintain the brand image in the digital market. Of course, the mandatory civil laws on commercial agents may be applicable, depending on the qualification of the agreement.

While commissionaire and other agency models were less prevalent in the market in the past decades, they have been resurrected since the rise of e-commerce and omni-channel.

C. How to Partner Successfully with Franchisees in a Digital Economy

Much of the digital revolution is carried out by working side by side with franchisees and other retailers. Sometimes, overcoming the challenges posed by the new economy may cause friction, in particular when control over the direction and vision of the brand or profit models are concerned. To avoid conflicts, franchisors and franchisees should make clear arrangements regarding e-commerce. In particular, the revenue and profit models for the website should be agreed upon and written down in detail in, or as an amendment to, the franchise agreement. For example, it could, in specific circumstances, be a good idea to negotiate that a franchisee gets a commission or service fee for services performed for the franchisor’s direct online sales to customers. Or, in the case of an exclusive territory allocated to the franchisee, the franchisee might receive a part of franchisor’s earnings of online orders of consumers in the territory of the franchisee. Any such arrangements may qualify as commercial agency within the meaning of EU law as implemented in its member states, even if the main agreement is a license or franchise agreement. Therefore, an analysis of its proper qualification, proper drafting,
and negotiating is helpful, even though some consequences of qualifying as a commercial agency, such as mandatory goodwill compensation, may not be possible to contract away if the agent is situated in the European Union.59

IV. The Collection and Processing of Consumer Data

In addition to the complexity of the various business and distribution models, it is now increasingly difficult to determine who “owns” the rights to customer data and who is responsible for the correctness, completeness, and safety of the data.60 The strict rules for personal data processing under the General Data Protection Regulation61 (GDPR) will impact franchise systems, not only within the European Union, but potentially worldwide.62 The GDPR applies to processing in the context of the activities of an establishment of a “data controller” or “data processor” in the European Union, regardless of whether the processing takes place in the European Union or not.63 A “data controller” is the natural or legal person, public authority, agency or other body that determines the purposes and means of the processing of personal data,64 while a “data processor” means the natural or legal person, public authority, agency or other body that processes personal data on behalf of the data controller.65 Moreover, the GDPR applies to the processing of personal data of data subjects who are in the European Union by a controller or processor not established in the European Union, where the processing activities are related to (1) the offering of goods or services, irrespective of whether a payment of the data subject is required, to such data subjects in the Union; or (2) the monitoring of their behavior as far as their behavior takes place within the European Union. This means that only franchise networks that do not have any business units or advertising activity, or individual online sales in the European Union and European Economic Area (EEA) can safely say they do not need to check for compliance with the GDPR and other EU privacy laws. If a franchise network has business units or advertising in the European Union, or just makes individual sales there, even if it is only through the franchisee’s website accessible from the European Union, accepting reservations, or making deliveries of products

60. See, e.g., note 21.
61. Council Regulation 2016/679 of April, 27, 2016 on the protection of natural persons with regard to the processing of personal data and on the free movement of such data, and repealing Directive 95/46/EC (General Data Protection Regulation), 2016 O.J. (L 119/1).
63. General Data Protection Regulation, supra note 61, art. 3(1).
64. Id. art. 4(7)in.
65. Id. art. 4(8).
or services to data subjects in the European Union, it is very likely that the GDPR is applicable to the franchisor or franchisee. Since violations of privacy laws by a franchisee can seriously harm the reputation of the brand, and thus affect the franchisor and the entire franchise network, franchisors also need to take account of a franchisee’s activities in the European Union, even if the franchisee is only accepting reservations or orders for products or services online.

To comply with the GDPR, franchisors and franchisees must map the data processing in franchise systems. This data processing may include client data (whether the client is a consumer, guest, or patient), employee data, and personal data relating to individuals visiting the premises and third-party service providers. Who will determine the purposes and means of data processing and thus will act as the data controller? Where will data rest? Which data will flow between the parties? How long will data be kept and who exactly needs access to data? Knowing the answers to all of these questions is of critical importance.

It is recommendable for franchisors and franchisees to clearly define all of these questions in their agreements. It is also important to align reality with what is stated in the agreements and other documentation. If the franchisee will act as a data processor—processing data on behalf of the franchisor—the franchise agreement must include processor clauses, meeting the requirements under the GDPR. If both parties act as joint controllers, they also must make an arrangement to determine their responsibilities for compliance under the GDPR. In our experience, most standard franchise agreements have used internationally require substantial adaptation to meet the requirements of the GDPR.

Contractual arrangements are of key importance to claims brought by any data subject, (i.e., the person whose data is processed). Any data subject who has suffered damage (material or non-material) as a result of infringement of the GDPR has the right to compensation from the data controller (or data processor if it defaulted in its specific role). Even if the franchisor and franchisees are not exempt from liability towards the data subjects involved, indemnification from the franchisor towards the franchisee (or vice versa, depending on what role each party has) may be included in franchise agreements. The same holds true for sanctions imposed by the competent supervisory authorities. Supervisory authorities may impose high fines of up to €20 million or 4% of the total worldwide annual turnover of the company in the preceding financial year.

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66. *Id.* art. 5.
67. *Id.* art. 4(1).
68. *Id.* art. 28(3).
69. *Id.* art. 26.
70. *Id.* art. 82(1).
71. *Id.* art. 84(5).
Finally, it is important to realize that there is more to come: the strict rules under the GDPR are expected soon to be complemented by additional e-privacy rules, which will impact usual business operations in franchising, such as consumer profiling, e-marketing, behavioral advertising, and geotargeting. Initially, Brussels set forth the ePrivacy Regulation in parallel with the GDPR on May 25, 2018. However, the draft ePrivacy Regulation is still being debated, and final adjustments are being negotiated. For international franchising systems, the final consequences for daily practice of this regulation are still unclear.

V. Influencers and Social Media

So-called “influencers,” people who are active on social and in other media, impact the development of luxury brand value. High couture and luxury product manufacturers (e.g., brand owners) use social media in many ways to their advantage. They develop a sophisticated brand strategy for this, and they seek influencers and brand ambassadors to enhance the brand image and the popularity of the brand’s products. Specific target audience groups are defined well in advance, and most brands work with multiple influencers to influence different target audiences. Franchisors also need to take actions to curtail unwanted social media involving their brands by third parties, or by their own multi/mono brand retailers. In particular regarding the latter situation, it is helpful for both franchisors and franchisees to implement social media guidelines.

While there are European rules on advertising, such as on misleading advertising and unfair trade practices, EU laws do not contain specific legislation on influencers and social media. To give an example, there is Dutch law on advertising and unfair trade practices, which is largely an implementation of EU law. Most of the rules are based on the principle that advertisements may not be misleading. For a few years now, several jurisdictions have adopted national laws and/or practices on the permissibility of social media influencing. In the Netherlands, for example, the Advertising Code Committee has introduced a system of self-regulation—the Dutch Advertising Code—and one of its sub-codes applies to influencing.

74. Id., n.25.
75. See, e.g., DCC, supra note 38, art. 6:194.
76. See, e.g., id. art. 6:193a–j.
The Advertising Code Social Media\textsuperscript{78} contains a self-regulation on social media advertising. Often an advertiser (for example, the brand or the manufacturer) asks the distributor (the blogger or influencer) to present its products in exchange for a financial compensation or other advantage. This is called influencer marketing. According to the Advertising Code Social Media, it must at least be clear that the post is an advertisement. In the case of a “Relevant Relationship,”\textsuperscript{79} the advertisement must be recognizable, and the distributor must state the compensation received.\textsuperscript{80} Sometimes it is unclear whether the blogger or influencer received actual remuneration due to the advertisement, or whether a product or brand is actually coincidental with the advertisement. In the first case, the influencer must explicitly mention the connection, either by using hashtags, such as #spon or #adv., or by literally saying that a specific product has been received from the brand. Article 3 of the Advertising Code Social Media offers suggestions for clearly identifying the content and nature of the Relevant Relationship.

The Advertising Code Committee supervises the Advertising Code Social Media. The Committee only acts on the basis of complaints. On November 17, 2015, after a complaint against three bloggers and the watch brand Daniel Wellington,\textsuperscript{81} the Advertising Code Committee ruled that, despite the absence of the suggestions presented in the Advertising Code Social Media, it still concerned advertising. The business relationship in this case was unmistakably clear because of the layout and presentation of the blogs and therefore fell within the scope of the Advertising Code Social Media.

\section*{VI. High Fashion and the Need for Speed}

Digital opportunities create the need for speed to meet consumer demand, a trend that is aptly called “velocity” in the fashion industry. An important development that affects the high fashion industry is the fact that the traditional practice of two high fashion collections per year is under pressure. The desire for high velocity and high turnover is forcing manufacturers and retailers to adapt by rethinking their manufacturing processes and supply chains.

Consumers can check online every day for new products that he or she may want to buy, and many websites are now willing to cater to this demand, making fresh new products available on a daily basis, putting pressure on brands to continually change product offerings. Social media encourages the


\textsuperscript{79} Art. 2(d) of the Dutch Advertising Code Social Media defines a “Relevant Relationship” as the relationship between the advertiser and the media disseminating the content that is targeting the advertising through social media and receiving payment or any other benefit which could influence the credibility of advertisement through social media.

\textsuperscript{80} Advertising Code Social Media, supra note 78, art. 3.

mentality that once an outfit or item is shared with the public, it can never be worn again and photographed. The problem with this psychological shift is that most people cannot afford to buy a high-end item and only wear it once. Fast fashion retailers are seeing the benefits of these trends’ shorter life cycles because it is resulting in people constantly looking for a product to satiate their moment of inspiration. By nature, the manufacturing lead times for developing and manufacturing products are longer for high couture brands than they are for their fast fashion counterparts.

High couture brands have responded in various ways. In other sectors of the fashion and apparel industry, more collections per year and flexible ordering have long been in place. There are some trends in “high couture” for changing the pace. Some high couture brands have resisted this trend in order to maintain quality and reputation. The trend of more collections per year has a major impact on how to market, sell, and distribute products. It can negatively impact the brand image and high quality reputation high couture brands have spent so long cultivating. Other high couture brands have more readily embraced changing marketplace. These innovators have explored cooperation for particular collections with cinema, music, and fashion or sports celebrities, bringing dedicated and specifically branded products to the public to stay “relevant” online. Another distinct response is the mixing of high couture with “fast fashion.” Some high couture brands have developed and sold specific “fast fashion” collections with brands like H&M, and other “fast fashion” champions. High couture no longer leads what is worn in the streets. Street wear quickly makes it into trends and into the high couture. The high couture retail year, with distinct seasons and four or five major inventory turns, is now generally believed to be a thing of the past for retailers and brands.82

The “see-now–buy-now” culture has also impacted the manufacturing supply chain and sales organization of high couture and other fashion brands. Traditionally, the industry works with pre-ordering and manufacturing cycles of at least six months. Most manufacturing is done overseas, in Asia. Therefore, additional time is needed for packaging, shipping, unloading, and delivery to warehouses of distributors or directly to owned stores, retailers, or direct sales channels. Velocity means that couture brands must have overseas factories engage in faster production, without compromising on quality. Brands also engage more directly with fabric and trim manufacturers, more often buying directly from them, and placing “bufferstock” with manufacturers. This means taking the ownership and risk earlier in the process, thus encompassing the financial risk of these materials not being used or not fit for the end product.

Similarly, capacity booking systems are usually software tools or other information technology systems that help with (monthly) production planning to maximize the profit of retailers. The bookings for production lines and manpower in production factories are conducted in advance based on a demand prediction and production planning. These capacity booking systems seem attractive for manufacturers and brands, but also increase the risk for the brand that the factory is booked in advance, all personnel and machines standing still if there is a problem with the designs, the fabrics, and other materials used. All of these changes require a different way of working, and an understanding with the manufacturers that time and quality is of the essence. Some factories overseas are not used to working based on long and complex contracts, while some can adapt to a very different way of working.

Most truly high couture brands have a long tradition of manufacturing in smaller quantities, closer to home. Interestingly, more brands have moved certain manufacturing processes closer to home, to avoid shipping time and to have more control over the manufacturing process and quality of the products. The importance of termination clauses in contracts cannot be overstated because a move to a new factory may have to be swiftly executed, or certain fall-back options may have to be used more often in the current digitally driven landscape. There is also a distinct impact on the sale and distribution of high couture—think of capsule collections, corner stores, and pop-up stores. Today’s retailers must be agile and flexible to stay relevant. Special agreements are needed not only for the operators of such stores, but also to make sure the agreements are fit for the situation at hand and not overly complex. If anything, it adds another sales channel in often already layered multi-tiered distribution and retailer or franchisee networks. Maintaining control of the brand and the brand’s vision and image remain key to success, and this requires a lot of resources to manage, such as policing the Internet for counterfeit and genuine products brought onto the market without the trademark holder’s permission from outside the European Union.

VII. Conclusion

New technologies and digital markets impact the online sale of fashion and luxury products globally. In this sector, suppliers often use multiple distribution channels, of which franchise or licensed monobrand stores form

83. A capsule collection features only the most essential or influential pieces from a collection. A capsule collection is often limited edition, which transcends seasons and trends by being functional—read commercial. They often focus on construction and delivering key looks and are used by fashion retailers to break seasonality as an alternative to fast-fashion.

84. A corner store is a small retail business that stocks a range of everyday items for convenience purposes.

85. A concept store is a retail format that integrates apparel, homeware, bookstore, gallery, and restaurant under a consistent brand personality and visual merchandising. The goal of a concept store is to stay away from mainstream fashion as much as possible.
an important part. Having multiple sales channels in place means there is
a need to continuously assess the positive and negative impacts, both com-
mercially and legally, of one channel on another, and to address any issues
that arise. Digitalization has truly transformed and further complicated this
retail environment. It creates a stronger focus on technology and on a clear
brand strategy that is aligned across all channels, both digital and physical.
This is even more true regarding the integration of traditional physical and
new digital channels, the so-called omni-channel. To survive, retailers today
need to create a seamless, omni-channel brand experience. This needs to be
aligned across owned retail and franchised or licensed retail locations, both
online and offline.

Profit models of integrated marketplace bring commercial opportunities
but also new risks and legal implications. Data and technology play a much
larger role in business than ever before. The more detailed information a
party has, the better the party can customize and design its products, ser-
vices, and brand strategy to what consumers really want, thus increasing its
success. Especially in Europe, where there is a tight framework of law in
which to operate, it can be challenging to navigate the waters. Competition
law also plays an increasingly important role. In owned channels, pricing
may be aligned between outlets, but in franchised or licensed channels, the
supplier may not influence the retailer’s pricing and discount strategy. Sup-
pliers may not prohibit internet sales with perhaps the exception of inter-
net platform restrictions. To maintain control over brand positioning, and
to avoid free riding by (pure online) retailers that may not invest as much
in quality and service, brand owners increasingly feel the need to protect
the luxury image of their products and to keep control on the quality of
their goods and service delivery through, for example, selective distribution.
However, not every franchise or license system of stores meets the crite-
ria of selective distribution, and having selective distribution in place also
provides additional regulatory complexities, such as the need to allow at all
times cross-sales between members of the network.

The desire for both high velocity and high turnover is forcing manu-
facturers and retailers to adapt by rethinking their manufacturing processes
and supply chains. Revised business models may change aspects of the
performance of the contracts between suppliers, retailers, and consumers.
For franchising, the changes in digital commerce and omni-channel there-
fore mean that franchise agreements may need to be revised to reflect the
changes and to clarify roles and responsibilities. In particular, agreements
should address profit-sharing models, roles and responsibilities regarding the
collection and processing of consumer data, and compliance with increased
consumer protection laws and competition laws on vertical restraints and
horizontal data sharing (if the supplier is also active at retail level). To avoid
conflict, franchisors and franchisees must define their roles, properly qualify
their agreements, and make clear arrangements regarding omni-channel and
e-commerce.
Franchising is booming in Italy with an ever-increasing industry gross domestic product of more than twenty-five billion euros, combined with an increasing number of units, a growing workforce, and a rise in overseas expansions. Franchising in Italy, however, remains underdeveloped compared to the U.S. or Australian markets. This growth potential is also evident in the number of master franchisees of foreign franchisors, representing only about 7.5% of franchise systems operating in Italy. Geographically, much of Italy remains open for franchising as franchisors have largely preferred the northwestern and central areas (i.e., areas around Milan and Rome). And, although the franchise industries are varied, clothing, food (restaurants, quick service restaurants, pizzerias, ethnic restaurants and ice cream shops), real estate services, mail services, and travel and tourism are the leading sectors, with food-based franchises in continuous expansion. Large-scale retailers (food and non-food) are also growing and represent the largest contributors to the gross domestic product of the entire franchise industry.

Despite the positive economic indicators for the business format, the Italian business and legal environment present complexities and differences when compared to the United States, in part, because Italy is a civil-law jurisdiction. As a result, an Italian franchise agreement may present substantial differences from its U.S. equivalent. In addition, the backbone of the Italian economy consists of small and medium companies, which may present difficulties, at times, for franchisors to identify appropriately sized master franchisees. On a positive note, Italy has a specific law regulating

1. Assofranchising, Annual Report 2019 (still to be published, data officially presented at the Assofranchising Tour in Rome on June 5, 2019). In 2018 compared to 2017, there was a 4.5% increase in number of units, a 3.8% increase in the workforce and a 7.6% increase in overseas units of Italian franchisors. Id.
2. Id. However, in 2018 compared to 2017, there was a 1.4% increase in number of master franchisees of foreign franchisors and a 21.7% increase of foreign franchisors located overseas and operating in Italy with only franchisees. Id.
franchising—primarily covering disclosures—and has developed a body of cases outlining the major areas of litigation. These circumscriptions make the prospects for a U.S. franchisor willing to enter the Italian market more clear and less complicated.

This article provides an overview of the franchise-related Italian legal landscape in an effort to more fully inform the decisions of U.S. franchisors when considering expansion into Italy.

I. The Legal System in Italy

A. The Legal Landscape

Italy is a civil law jurisdiction and a member of the European Union. As opposed to the often conflicting and always changing judicial decisions in the United States federal courts and most U.S. states’ courts, Italy’s civil law is a codified system of laws based on specific codes and laws for each area. Only legislative enactments are binding; judicial decisions are not. But, in practice, judges tend to follow court precedents, in particular those issued by the Italian Supreme Court (Corte di cassazione). The Italian civil code is designed to deal with the areas of private law relevant for contracts and torts, specifically including franchise regulation. It is also worth noting that European Union regulations (and European Union treaties) directly apply in Italy as a member of the European Union. This European Union overlay is of importance, particularly with respect to matters involving competition or antitrust laws, where, for example, a European Union regulation establishing the criteria that vertical agreements must satisfy in order to fall into a block exemption that applies to franchise agreements in Italy.

One of the practical consequences of being a civil law system is that contracts are generally shorter than those drafted in the United States because a number of provisions naturally apply to the contract to regulate the relationship between the parties. Also, clauses that parties might have scrutinized and litigated as vague or uncertain may sometimes be clarified through the general principles set out in the Italian civil code. A good example is the concept of good faith that is so often litigated in U.S. courts. In Italy, it is a firmly established concept that regulates the entire contractual relationship from onset to termination, or even during earlier, pre-contractual

5. The Italian civil judicial system encompasses three tiers: first instance (Tribunale), appellate courts (Corte di Appello), and finally, the Corte di Cassazione, or Cassazione Sezione Civile, for civil cases.


7. As a member state, Italy also has the duty to transpose European Union directives into national law.

stages of negotiation. Good faith is relevant for the interpretation of the contract throughout its duration and affects how the parties must behave at its termination.

B. Doing Business in Italy

A U.S. franchisor may enter the Italian market using all the structures normally adopted in international franchising. The Italian legal system poses no particular restrictions or limitations that negatively impact a foreign party’s ability to set up a local subsidiary, branch office, or joint-venture company. No significant restrictions affect any commercial cooperation with a local partner. Furthermore, foreign investments in Italy are free and encouraged by the government, and no restrictions apply to foreign business entities (with the limited exception of sectors considered of national interest). If a U.S. franchisor wants to be directly present in Italy, there are a number of alternatives, ranging from forming a representative office to setting up a subsidiary. The first option, the representative office, cannot perform any type of commercial or financial operations but may only conduct research, advertising, and marketing. Thus, a franchisor may open a representative office as a first step in preparation for subsequent, more structured activity. A representative office requires registering with the register of companies and the appointment of a legal representative that will need an Italian tax identification. A branch or subsidiary, on the other hand, is considered a permanent establishment by the Italian tax authorities, which triggers the same tax duties and requirements applicable to any company doing business in Italy (e.g., preparing balance sheets, filing tax returns). Most likely, a U.S. franchisor wanting to carry out business operations in Italy will set up a subsidiary, in the form of a joint stock company (società per azioni (s.p.a.)) or a limited liability company (società a responsabilità limitata (s.r.l.)). Both are business entities allowing a franchisor to limit its liability to the assets contributed to the entity and therefore control the risk. Finally, there are no restrictions for local franchisees to make payments to a U.S. franchisor, in U.S. dollars, euros, or other currency.

II. Regulation of Franchising: A Brief Overview

A. Disclosing the Franchise Agreement and the Disclosure Document

Regulation of franchise operations in Italy is mainly achieved by Law 129/2004, which is essentially a disclosure statute. Other than Law 129/2004, no filing, approval, or registration requirements exist from any regulatory authority specifically addressing franchise issues.

9. C.c. arts. 1337, 1338, 1366 & 1375 (It.).
10. C.c. art. 2462 et seq.; id, art. 2325 et seq. (It.).
12. Registration of intellectual property rights prior to entering the market is highly advisable but not required.
A franchise is defined as any agreement where one party grants the other party the right to use certain intellectual property rights for trademarks, trade names, shop signs, copyright, know-how, patents, commercial support and assistance, in exchange for compensation, and the franchisee is allowed to join a franchise network operating in certain territories for distribution of goods or services.\(^{13}\) The law applies to contractual relationships that fall into this definition, regardless of how the parties decide to qualify or otherwise attempt to define the contract. Any offer or sale of a franchise carried out in Italy will trigger the application of the law. Foreign laws governing the franchise contract do not preempt the obligation to effect disclosure in compliance with Law 129/2004.\(^{14}\) International franchisors operating in Italy for the first time, however, are subject to a less broad disclosure.\(^{15}\)

Italy does not have a legal requirement that a new franchisor have operated a pilot or initial franchise in Italy, but a franchisor should have previously tested the franchised concept in a market, where “market” is intended to cover any geographical location in the world.\(^{16}\)

Law 129/2004 requires that, thirty days before a franchisee signs the franchise agreement or commits to payment related to the franchise rights, the franchisor must deliver the contract and certain delineated information to the prospective franchisee.\(^{17}\) This disclosure obligation applies to a franchisor vis-à-vis its master franchisees and its direct franchisees, to master franchisees vis-à-vis their franchisees, and in connection with franchise development and multi-unit agreements.\(^{18}\) The requisite information identified by statute is not exhaustive because the law requires the franchisor or master franchisee to disclose any information relevant to the franchise relationship.\(^{19}\) The statutory list includes information regarding the development and structure of the franchise system, corporate information on the franchisor and its intellectual property rights, litigation history, and fees and other expenses or investments a franchisee has to bear to enter the franchise system.\(^{20}\) Consequently, it is advisable to include in the franchise agreement an acknowledgment from a prospective franchisee that the franchisor made the appropriate disclosure to the franchisee’s satisfaction. In light of the extensive disclosure, a franchisor may want to protect those disclosures with a confidentiality or non-disclosure agreement to be signed prior to any exchange of confidential information.

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13. L. n.129/2004 (It.).
16. L. n.129/2004, art. 3 (It.).
17. Id. art.4.
18. Id. art. 2.
19. L. n.129/2004, art. 6 (It.) (governing the pre-contractual obligation to behave in good faith and disclose any material information to allow the other negotiating party to make a reasonable business decision in relation to the franchise relationship; it also applies to the franchisee’s disclosure of material information).
Law 129/2004 also requires that any franchise agreement must allow sufficient time for a franchisee to recover its investment costs, or continue for a minimum term of three years.21 Franchise agreements having a shorter duration are by law considered valid and binding for three years.22 This requirement may pose an issue to a U.S. franchisor that wants to conduct a test or pilot with the selected partner before committing to a longer, more normal franchise agreement term.

B. Continuing Requirements

A franchisor does not have the duty to update the disclosure document once the parties execute a franchise agreement. Once agreed upon, both parties have a duty to execute the contract, perform their obligations, and generally behave in good faith toward each other throughout the franchise relationship and at its termination.23 In Italy, the duty of good faith has a broad application and serious impact on judicial decisions. Good faith requires that each party, if it is not too much sacrifice for the party in question, refrain from acting in ways that would damage the other party, regardless of whether a specific contract provision prohibits the behavior.24 For instance, although a franchise agreement failed to prohibit a franchisee from selling franchised goods through alternative distribution channels (e.g., large retailers), the Court of Milan, broadly interpreting other provisions of the contract concerning distribution of the products, decided that a franchisee had no right to sell to large retailers based on a violation of the duty of good faith.25 The court held that the contract had to be performed in good faith, which precluded the franchisee from deciding on a marketing or distribution strategy damaging to the franchisor’s interests (as sales to large retailers were cheaper than in small shops).26

Similarly, a franchisor must also comply with the duty of good faith. A franchisor cannot create unjust expectations for renewal of the franchise agreement, especially when a franchisee has made significant investments in the franchised business and is subsequently damaged by the nonrenewal.27 Under Italian law, a franchisee may seek payment from the franchisor of the expenses and investments that it made in reasonable reliance on an anticipated contract renewal.28
C. Termination of the Franchise Agreement

Either party has the right to terminate a franchise agreement in the event of a material breach, regardless of the absence of an express contractual provision regarding a right to termination. The breach must be relevant and material. Examples of actionable breaches include the franchisor’s failure to deliver the promised training or know-how to operate the franchise; the franchisor’s failure to provide assistance and support as agreed in the contract; or a franchisee’s failure to pay a substantial amount owed for purchased goods or royalties. Alternatively, the parties may indicate in the franchise agreement the obligations they respectively consider of material importance therefore triggering the non-defaulting party’s right to terminate the agreement. It is common practice to insert a provision where the non-defaulting party gives the defaulting party time to cure the breach, which, if not remedied timely, triggers termination of the contract.

D. Penalties for Breaching the Franchise Laws

In the event a franchisor breaches the statutory disclosure requirements, the non-defaulting party may terminate the agreement and request damages for any loss suffered as a consequence of the breach of the disclosure requirements. In practice, franchisees mostly claim that franchisors breached the disclosure requirements only after the contract has been in effect for many years. The time element often makes it difficult for franchisees to prove that the damages suffered are a consequence of a disclosure failure. Parties also seek damages for franchisee misrepresentations in negotiations and failure to perform contractual duties in good faith. Similarly, these breaches require that any alleged damages be a consequence of the alleged breach.

III. The Franchisor-Franchisee Relationship in Italy: Other Relevant Legislation

Numerous other laws may impact a U.S. franchisor’s relationship with its Italian franchisees. This section will take a non-exhaustive look at some of the issues raised by these laws.

29. C.c. art. 1453.
30. Trib. Trento, 14 maggio 2012 (It.).
31. Trib. Ferrara, 22 marzo 2012 (It.).
32. Trib. Frosinone, 21 giugno, 2016 (It.).
33. Trib. Roma, Sez. IX, 4 giugno, 2009 (It.).
34. C.c. art. 1456.
35. Id. art. 1454. While the civil code mentions a fifteen-day period to cure the breach, sometimes, due to specific circumstances, a longer period is advisable.
36. L. n. 129/2004, art. 8 (It.).
A. Trademarks

Registering a U.S. franchisor’s trademarks in Italy as soon as possible—preferably even before starting conversations to launch the business is strongly advisable because the holder of the registered trademark acquires the right to the exclusive use of the trademark and obtains full protection against third parties using identical or similar marks. A franchisor can file trademark registration with the Italian Office for Patent and Trademarks or through the Madrid System for Trademark International Registration. Prior to registration, a franchisor, as a best practice, should conduct a search with the chosen registration office to inquire about the registration of any similar trademarks in Italy. To be registered, a trademark must be new, which means that it must not be anticipated by other identical or similar registered trademarks.37

B. Abuse of Economic Dependence

At the time of termination or nonrenewal of their franchise agreement, some franchisees attempt to enforce the Italian law prohibiting the stronger party in a contractual relationship from abusing economic dependence of the other party.38 According to this law, which is known as the law on industrial sub-contracting, “economic dependence” refers to a situation where one entity is in a position to create an excessive imbalance of rights and obligations in its undertakings with another entity.39 The law does not punish the mere existence of economic dependence but only the stronger party’s abuse of that economic dependence through the contractual language or abusive behaviors.40 In evaluating economic dependence, the law also considers whether the victim of the abuse may likely find any satisfactory alternatives within the market.41 Where a franchise agreement is one with a definite term or with a reasonable notice period prior to termination, it would be difficult for a franchisee to prove that it was not able to find an alternative way to sell products or services on the market and that a franchisor had committed an abuse by not renewing the agreement or terminating it.

Of all the decisions issued by Italian courts on the application of the law on industrial subcontracting to allegedly abusive nonrenewals of franchise agreements, the most illustrative are the ones issued by the Court of Rome in

39. Id.
40. For instance, Provvedimento of the Autorità Garante della Concorrenza e del Mercato (the Italian Competition Authority), 23 novembre 2016, n. 26251, in Bollettino n.44, Dec. 12, 2016. The Italian Competition Authority sanctioned a company active in the gas distribution sector for systematically delaying payments due to its suppliers of gas meters. Payments were made after 120 calendar days in lieu of the sixty calendar-day term provided by the decreto legislativo 9 novembre 2012, n. 192, G.U. Nov. 15, 2012, n.267 (It.).
41. Id.
2015. In six similar cases involving the franchisor Avis Budget Rent-a-Car, regardless of the franchise agreement’s express provision permitting nonrenewal, the franchisees claimed that Avis arbitrarily interrupted the business relationship and that they were unable to recover their investments. Therefore, given their economic dependence on Avis, the nonrenewal of the franchise agreement was abusive and in violation of the prohibition of abuse of economic dependence established by Law 192/1998, article 9. The Court of Rome held that the franchisor exercised a known, express, and acknowledged right to nonrenewal and acted in compliance with the notice requirements that allowed either party to not renew. Accordingly, the court found the nonrenewal was not unexpected or arbitrary and thus not abusive.

C. Competition Laws

The Italian competition law is not specific to franchise agreements but does apply to them. Article 2 prohibits anticompetitive agreements, and Article 3 prohibits the abuse of a dominant position. The law mirrors the corresponding provisions of the Treaty on the Functioning of the European Union (TFEU). The provisions of the Italian competition law refer to an effect on trade within the national market, or a relevant part of it, in lieu of an effect on trade in the European Economic Area’s internal market. The provisions of the TFEU, as well as the European Union regulations, have direct application in the member states in the event that the market affected by the anti-competitive behavior or the abuse of the dominant position is the broader European Economic Area’s internal market. Furthermore, the Italian law provisions should be interpreted in accordance with the principles established by the European Union’s competition authorities. By law, civil courts rule on anti-competitive behavior to establish issues like antitrust damages.

The Italian competition authority—Autorità Garante della Concorrenza e del

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44. Id.
45. Id.
47. L. n.287/1990, arts. 2, 3 (It.).
48. Treaty on the Functioning of the European Union, Mar. 25, 1957 (TFEU). TFEU Article 101 regulates cartels and other agreements that could disrupt free competition in the European Economic Area’s internal market. TFEU Article 102 prohibits the abuse of a dominant position affecting trade between member states. The system is replicated in most European countries, for instance for the United Kingdom. See John Pratt & James Barrett, Franchising in the United Kingdom, 38 Franchise L.J. 1, 6–8 (2018).
49. L. n. 287/1990, art. 1, para. 4 (It.).
Mercato—oversees the prosecution of cartels and abuse of dominant position matters.

Agreements in violation of Article 101 of the TFEU (or only the infringing provision, depending on how serious the violation) are void and unenforceable, and the parties may be subject to a fine based on the gravity and the duration of the infringement and capped at ten percent of worldwide turnover (i.e., sales, of the business concerned, including turnover of associated companies).\(^{51}\) Likewise, for anticompetitive agreements or abuse of dominant position, the Italian competition authority may impose fines of up to ten percent of the worldwide turnover each undertaking realized during the previous fiscal year.\(^{52}\) Some anticompetitive covenants in franchise agreements may violate the prohibition to restrict competition, mostly at a national level. The European Commission Block Exemption Regulation and interpreting guidelines, however, create a possible safe harbor for vertical agreements in general.\(^{53}\) The regulation exempts vertical agreements from the prohibition on restrictive agreements under the TFEU, so long as (1) the market share held by the franchisor does not exceed thirty percent of the relevant market on which it sells the contract goods or services; (2) the market share held by the franchisee does not exceed thirty percent of the relevant market on which it purchases the contract goods or services;\(^{54}\) and (3) the agreement does not contain “hardcore restrictions.”\(^{55}\) Because the relevant market is the entirety of, or a substantial part of, of the European Union, the block exemption may apply to the majority of franchise agreements without hardcore restrictions. A franchise agreement protected by the umbrella of the block exemption, will also be safe under Italian law and not considered restrictive of competition.\(^{56}\)

In addition to the Block Exemption Regulation, the European Commission Notice on Agreements of Minor Importance applies to agreements not capable of appreciably affecting trade between member states and similarly provides an exemption for those agreements that generally fall outside the prohibition of article 101(1) of the TFEU regulating anticompetitive agreements.\(^{57}\) A franchise agreement of “minor importance” under the criteria and


\(^{52}\) L. n. 287/90, art. 15 (It.).


\(^{55}\) TFEU, supra note 48, art. 101(1).

\(^{56}\) Article 4 of the Italian competition law, contains an exemption which is similar to the one in TFU Article 101(3), which is the basis of the Block Exemption Regulation.

threshold of the European Commission Notice, in order to benefit from the safe harbor created by the market share and turnover threshold, also must not contain any “hardcore restrictions” as defined in the Block Exemption Regulation. It is therefore of paramount importance to examine the typical provisions of a commercial agreement that the TFEU may consider “hardcore restrictions,” including any of the following.

1. Resale Price Maintenance

A franchisor may set maximum and recommended selling prices, but price fixing (i.e., setting minimum prices), whether contractually or through conclusive behaviors (pressure or incentives), is considered a hardcore restriction. A franchisor may participate in limited resale price maintenance activities under special circumstances—new product launch or coordinated short-term low-price campaign (two to six weeks maximum in most cases).

2. Restrictions on Passive Selling

A franchisor can prohibit its franchisees from “actively” selling in each other’s territory, but it cannot impose a general ban on passive sales. According to the Guidelines:

“Active” sales mean actively approaching individual customers by for instance direct mail, including the sending of unsolicited e-mails, or visits; or actively approaching a specific customer group or customers in a specific territory through advertisement in media, on the internet or other promotions specifically targeted at that customer group or targeted at customers in that territory. Advertisement or promotion that is only attractive for the buyer if it (also) reaches a specific group of customers or customers in a specific territory, is considered active selling to that customer group or customers in that territory.

“Passive” sales mean responding to unsolicited requests from individual customers including delivery of goods or services to such customers. General advertising or promotion that reaches customers in other distributors’ (exclusive) territories or customer groups but which is a reasonable way to reach customers outside those territories or customer groups, for instance to reach customers in one’s own territory, are considered passive selling. General advertising or promotion is considered a reasonable way to reach such customers if it would be attractive for the buyer to undertake these investments also if they would not reach customers in other distributors’ (exclusive) territories or customer groups.

The distinction is of particular relevance for online sales and advertising through the Internet.

A five percent market share threshold and a forty million euro turnover threshold are to be regarded as criteria for identifying agreements in principle not capable of affecting trade between member states, in accordance with paragraph 4 of the Commission Notice.

58. Block Exemption Regulation, supra note 54, art. 4.
60. Id. para.51.
3. Post-termination Non-compete Obligation

Any post-termination obligation requiring the franchisee not to manufacture, purchase, sell, or resell goods or services is considered a hardcore restriction, unless it is limited to a maximum period of one year post termination, limited to competing goods or services, limited to the “premises and land” where the franchisee has been operating, and indispensable to protect the franchisor’s know-how.61

D. Unfair Commercial Practices

In addition to disclosure regulations applying before signing a franchise agreement, U.S. franchisors must also consider that the Italian competition authority protects franchisees from franchisors’ misleading advertising.62 The authority may impose sanctions ranging from 5,000 to 500,000 euro, additional sanctions from 10,000 to 150,000 euro for non-compliance with the authority’s decisions, and the suspension of the business activity for up to thirty days in the event of repeated non-compliance.

Some recent decisions of the Italian competition authority have stated that misleading advertising includes:

• Offering potential franchisees the opportunity to realize certain and constant earnings;63

• Claiming, if untrue, extensive experience, expertise, and success in the home video distribution business; assuring a rewarding economic return with a moderate investment, substantial gains, and economic success, and two years’ repayment on investment;64

• Failing to disclose in the advertising on websites, direct e-mail marketing, and magazines that (1) to achieve a certain annual turnover, it is necessary to actively search for new clients at local level (regardless of subsequent meetings where the point was clarified), and (2) the business model was based on delivery effected through third parties and not directly by the franchisees, with consequent increased expenses and reduced earnings;65 and

61. Id. para. 69; Block Exemption Regulation, supra note 53, art. 5(3).
63. Provvedimento of the Autorità Garante della concorrenza e del mercato 9 luglio 2014, n.25022, DIF.&CO.-Original Poster Franchising, in Bollettino n.32, Aug. 11, 2014 (It.).
64. Provvedimento of the Autorità Garante della concorrenza e del mercato 15 marzo 2007, n.17609, Areafilm, in Bollettino n.43, Dec. 7, 2007 (It.). The decision has been followed by several decisions of the Italian competition authority as the misleading advertising was repeatedly put in place on different websites. See Provvedimento of the Autorità Garante della concorrenza e del mercato 7 agosto 2008, n.18717, Areafilm-Formula Di Affilizione Innovativa, in Bollettino n.43, Sept. 2, 2008; Provvedimento of the Autorità Garante della concorrenza e del mercato 21 dicembre 2011, n. 23139, Megamondo-Metodo Franchising, in Bollettino n.1, Jan. 23, 2012 (It.).
Claiming that franchisees may achieve a certain average annual turnover when untrue; failing to disclose that profits are heavily subject to products being displayed in local shops within the exclusive territory; and promising a bank loan when the grant is completely subject to the bank’s discretion.\(^{66}\)

Finally, it is possible that, under certain situations, franchisees may be considered “consumers” for the purposes of the protection granted against unfair or aggressive commercial practices of franchisors.\(^{67}\) For instance, the franchisees in *Eco-Store* claimed that the franchisor’s threats to close their units and commence legal action against them as a result of their complaints, was an “aggressive” and unfair practice. There, the antitrust authority did not consider the franchisor’s behavior an aggressive practice.

E. The EU General Data Protection Regulation

Processing of personal data and free movement of personal data are regulated in Italy by Legislative Decree 196/2003 (Data Protection Code),\(^{68}\) as amended to implement the new EU Regulation 2016/679 (GDPR).\(^{69}\) The definition of personal data includes name, identification numbers, location data, and even email addresses.\(^{70}\) The action of processing personal data is also defined very broadly,\(^{71}\) and the two definitions together make the Data Protection Code applicable in practice to any business operating in Italy. Pecuniary and criminal sanctions shall apply in the event of violation of the Data Protection Code.\(^{72}\)

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69. Council Regulation 2016/679 of April, 27, 2016, on the protection of natural persons with regard to the processing of personal data and on the free movement of such data, and repealing Directive 95/46/EC (General Data Protection Regulation), 2016 O.J. (L 119/1) [hereinafter GDPR].
70. Id., art. 4(1) (“‘[P]ersonal data’ means any information relating to an identified or identifiable natural person (‘data subject’); an identifiable natural person is one who can be identified, directly or indirectly, in particular by reference to an identifier such as a name, an identification number, location data, an online identifier or to one or more factors specific to the physical, physiological, genetic, mental, economic, cultural or social identity of that natural person.”).
71. Id., art. 4(2) (“‘[P]rocessing’ means any operation or set of operations which is performed on personal data or on sets of personal data, whether or not by automated means, such as collection, recording, organization, structuring, storage, adaptation or alteration, retrieval, consultation, use, disclosure by transmission, dissemination or otherwise making available, alignment or combination, restriction, erasure or destruction.”).
72. See Pratt & Barrett, supra note 48 at 15–17 (providing short, but direct, description of the GDPR’s impact on franchisors and franchisees in Europe).
F. Employment and Labor Considerations

Employment is heavily regulated in Italy, by statutes and by collective bargaining agreements, and covers about every aspect of the employer-employee relationship—from the duration of the employment contract, working hours, minimum wage, dismissals, severance payment, holidays, illnesses, etc. However, when an actual franchise agreement is in place, the law treats franchisees as independent entrepreneurs, and Italian courts largely support this approach. However, franchisees (or a franchisee’s employees) may claim that they are in fact employees of the franchisor or that the franchisor is their joint employer with the franchisee, if the franchisor is, in practice, the one controlling and managing the franchisee’s business. Similar to the classic joint employer determination in the United States, the parameters to address the issue are the franchisor’s right to hire and fire franchisee’s personnel, the right to set hours of work and rates of pay, and the right to give directions on the work performed. The fact that parties indicated their status in either the franchise agreement or an employment agreement is disregarded if in reality the franchisor manages the activities of the franchisee’s employees (e.g., indicating how to behave with customers or assigning sales’ targets).

Generally, employees are protected in the event of a transfer of business, which may occur, for example, when a franchisor takes over the operation of a previously existing franchised business. More precisely, a business transfer triggers the employees’ protection regime when it is “a functionally independent part of an organised economic activity and identified as such by both the transferor and transferee at the time of its transfer.” In such event, employees of the transferred business unit automatically pass to the purchaser with all their rights and protections and without requiring express consent. The transfer itself cannot justify the employees’ dismissal.

Working residence permits in Italy are necessary for non-EU citizens and granted for limited period of time only. Non-EU citizens must also obtain a work visa from the Italian Consular authorities before coming to Italy.

G. Premises

In the event the franchised business requires the use of retail outlets or other commercial space, it is important to take into account the mandatory rules regarding the lease of commercial premises. Commercial leases cannot last less than six years, or nine years for hotel leases. Furthermore, commercial leases are automatically renewed at the first expiration date for an additional six years (or nine), unless either party gives notice of nonrenewal.
twelve months (or eighteen in case of hotels) in advance of the expiration date.77 And, the circumstances for which a landlord can refuse to renew a lease agreement are limited. Using the premises for itself, or a plan to demolish and rebuild them, or to refurbish the building to comply with certain regulations would allow the landlord to refuse its consent to the tenant’s request to renew the lease agreement.78 When the second term has expired, the landlord can refuse the renewal without the need to indicate specific reasons. However, the lease term cannot exceed thirty years.79 All commercial lease agreements must be registered with the tax offices by payment of the relevant tax.80

H. Class Actions

Class actions are not regularly used in Italy, but it is worthwhile to address them briefly, particularly in light of the new law approved by the Italian Parliament on April 3, 2019, which goes into effect in a year from its publication in the Official Gazette.81 The new law brought some significant changes that may potentially increase class action cases. Under the new regime, a group of individuals (no longer exclusively consumers) can file a class action lawsuit against a business when they have “homogeneous” interests.82 In addition, eligible class members can claim damages on both a contractual and a tortious basis.83 This opens up the possibility of using these tools not only to protect the rights of consumers but also to protect rights in the fields of environmental law and financial services. Under the new regime, individuals can join the class action not only in the initial phase of the proceeding but also after the final decision on the merits of the case has been issued, with the advantage of a longer opting-in window.84 Joining a class action lawsuit means that the consumer can no longer bring an action based on same grounds, and he or she has to accept the outcome of the collective lawsuit85 (although the settlement or waiver of action cannot affect the non-consenting consumer).86 Finally, the new law sets out that the attorney of the class members must receive a fee determined by the Ministry of Justice (and a success fee determined by the judge of the proceeding); the “common representative” of the class members is also compensated, based on the number of the class members in accordance with the parameters established by the new

77. Legge n. 392/78, art. 28 (It.).
78. Legge n. 392/78, art. 29 (It.).
79. C.c. art. 1573 (It.).
81. Legge 12 aprile 2019, n.31, G.U. Apr. 18, 2019, n.92 (It.).
82. L. n. 31/2019, art.1 (It.) amending C.p.c. art. 840-bis.
83. (It.).
84. L. n. 31/2019, art.1 (It.), amending C.p.c. art. 840-sexies (It.).
85. Id., art.1 (It.), amending C.p.c. art. 840-undecies (It.).
86. Id., art.1 (It.), amending C.p.c. art. 840-bis (It.).
law. Under the present regime, consumers have the possibility of filing a class action only if based on breach of contract, product or service liability (regardless of the presence of a contractual obligation), or unfair and anti-competitive commercial practices. Many of the existing class action cases were brought by consumers following decisions by the Italian antitrust authority to sanction a business for unfair commercial practices.

**IV. Conclusion**

Italy represents for U.S. franchisors an attractive market with significant development potential. It is also a multifaceted country with a legal system that, at first sight, may appear complicated. On the positive side, Italy lacks the complex franchise disclosure and registration laws that are omnipresent in U.S. franchising. Although statutory protections of employees and consumers are strong, Italy has had a trend of court decisions supporting franchising as a valuable tool for carrying out a business in Italy.

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87. Id. art.1 (It.), amending C.p.c. arts. 840-octies & 840-novies (It.).
89. Autorità Garante della Concorrenza e del Mercato.
ANTITRUST


The U.S. District Court for the Eastern District of Michigan held that Harley Blanton (Blanton), a former employee of a Domino’s franchisee, stated a claim for violation of the Sherman Act against the Domino’s franchisor (Domino’s) and related entities.

Blanton alleged that he had worked at a Domino’s franchise, but quit after his hours were reduced. The franchise agreement between Domino’s and the franchisee for whom Blanton had worked included a “no-hire” provision. That provision stated that the franchisee would not hire, without prior written consent from the appropriate party, any person who is employed by Domino’s, an affiliate of Domino’s, or a franchisee of Domino’s. The franchise agreement stated that a violation of this provision caused Domino’s irreparable harm and was grounds for termination of the agreement.

Blanton brought a putative class-action against Domino’s and number of affiliated companies alleging that the franchise agreement “unreasonably restrains competition for Domino’s franchise employees and depresses employee wages, lessens employee benefits, and stifles employee mobility.” Specifically, Blanton alleged that the no-hire provision in the Domino’s franchise agreement amounted to a horizontal restraint on trade. Domino’s and the other defendants filed a motion to dismiss arguing that Blanton lacked Article III standing or antitrust

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standing, failed to state a claim under the Sherman Act, and failed to state a plausible claim against all defendants. The defendants also asked the court to limit the putative class to only the last four years.

Addressing Article III standing first, the court stated that Blanton must allege facts showing an injury-in-fact, causation, and redressability. Blanton had alleged that the purported scheme of the defendants injured him by depressing his wages and limiting his employment mobility. The court held that economic injuries like depressed wages have long been recognized as a basis for Article III standing and satisfied the injury-in-fact requirement. It went on to explain that causation and redressability were satisfied because Blanton alleged that the actions of the defendants caused his injuries and that the treble damages he seeks would redress his injuries.

Next, the court addressed the antitrust injury requirement, which simply requires the plaintiff to show that the injury he claims is the type of injury the antitrust laws are intended to address. The court quickly found that Blanton sufficiently alleged an antitrust injury, and it explained that courts commonly find impairments to employment opportunities as antitrust injuries.

The court then addressed whether Blanton had adequately alleged a violation of the Sherman Antitrust Act. Blanton argued that the no-hire provision violated the Sherman Act under either the per se or “quick-look” standard. The defendants argued that the proper standard was the “rule of reason” and that Blanton did not state a claim under it. The court declined to choose a level of analysis, instead concluding that Blanton had clearly stated a plausible claim. The court noted, with little further analysis, that the allegations that the no-hire provision was used to prohibit employment opportunities, and lacked any clear redeeming economic qualities, stated a plausible antitrust violation under the per se or quick look standards. Interestingly, the court did not reference the rule of reason when analyzing whether Blanton had stated an antitrust claim.

Next, the defendants argued that Blanton had not plausibly alleged an antitrust claim against the non-franchisor defendants who were affiliated with Domino’s. The court quickly rejected this argument, explaining that the complaint alleged adequate facts against each defendant showing how they purportedly participated in the alleged conspiracy.

Finally, the defendants sought to dismiss all claims outside the four-year limitation period. Blanton asserted that the defendants had fraudulently concealed their conspiracy and that these fraudulent actions tolled the statute of limitations. The court focused on whether Blanton’s allegations of fraudulent concealment satisfied Federal Rule of Civil Procedure 9(b)’s heightened pleading requirements for fraud. The court concluded that Blanton had met this standard and focused on Blanton’s allegations regarding specific statements that the defendants had made to the public that were inconsistent with the no-hire provision. The defendants also argued that Blanton had not acted with due diligence to discover the fraud because Domino’s made its franchise agreements publicly available. The court rejected this argument.
too because Blanton alleged that, for the most part, the franchise agreements were not publicly available and that, even when they were, franchise employees had no reason to know where those agreements were made public. The court further noted that the defendants failed to show where or how Blanton could have found copies of the franchise agreement. Thus, Blanton had plausibly alleged fraudulent concealment.

ARBITRATION


In this case, the U.S. District Court for the Western District of Missouri held that a former employee must arbitrate her antitrust claims against the indirect parent and its affiliate of her former employer on an individual basis.

Janice Davidow (Davidow) worked for an entity that was part of the H&R Block corporate family as a seasonal tax preparer in 2011 and 2012. As part of her employment, she signed two agreements, each containing similar arbitration clauses that required her to arbitrate various categories of claims on an individual basis only. Among other things, the arbitration clauses required arbitration of contract claims, common law claims, and claims arising under state or federal statute. The arbitration clauses further stated that they covered disputes with both her employer and any of its “parents, subsidiaries, affiliates, predecessors, and successor corporations.” After her employment ended, Davidow brought a putative class action against H&R Block, Inc. and H&R Block Tax Services, LLC (collectively, the H&R Block Entities) alleging that a no-hire provision contained in the standard H&R Block franchise agreement violated the Sherman Act. The H&R Block Entities responded by filing a motion to compel individual arbitration.

Davidow opposed arbitration by arguing that there was not sufficient consideration for the arbitration clauses because, in her view, they were not mutual. Specifically, she argued that they did not require arbitration of claims that her employer was likely to assert, but required arbitration of claims that she and other employees were likely to assert. The court rejected this mutuality and consideration argument. It held that, while it was certainly true that employees may assert claims covered by the arbitration clauses more frequently, there were many situations where the employer would affirmatively bring arbitrable claims against Davidow and other employees. It further noted that the claims exempted from arbitration were not limited by party type, that is, all parties had to arbitrate the covered claims regardless of whether they were the plaintiff or defendant.

Davidow next tried to argue that the H&R Block Entities could not compel arbitration because they were not signatories to the agreements. The court recognized the general rule that non-signatories who are sufficiently close to the contracting parties can enforce an arbitration agreement if necessary to avoid evisceration of the arbitration agreement. The court then
held that, under the agreements’ plain language, the H&R Block Entities could enforce the arbitration clauses because they explicitly state that they apply to her employer’s parents and affiliates.

Despite this plain language, Davidow argued that the agreements did not define the terms “parent” and “affiliate” and therefore she did not know that the agreements covered the H&R Block Entities. The court rejected this argument too. It noted that there were multiple indications in materials she received that these terms covered the H&R Block Entities. Among other things, H&R Block, Inc.’s code of conduct and policies were referenced in her employee handbook, she elsewhere acknowledged that she was receiving access to the confidential information of “H&R Block” generally, and she was told that she had to contact “H&R Block-Legal Department” if she wished to opt-out of the arbitration clauses. Considering these facts, Davidow certainly knew that H&R Block broadly meant her employer and the H&R Block Entities.

Finally, Davidow tried to argue that her claims fell outside the scope of the arbitration clauses. The court concluded that the claims were within the scope. It explained that one category of arbitrable claims was those arising under a federal statute. Davidow was suing under the Sherman Act, a federal statute. Thus, the claims easily fell within the scope of the arbitration clauses.


Adopting the findings of a Magistrate Judge’s report and recommendation (the Report), and overruling both parties’ objections thereto, the U.S. District Court for the Eastern District of Texas referred the parties to private arbitration under the Federal Arbitration Act and pursuant to the terms of a development agreement for barbecue restaurants in Utah into which the parties had entered (the Development Agreement).

The court’s opinion is sparse on facts, referring to a “long and complex history, spanning multiple proceedings in multiple courts.” Each party asserted objections to the Report. Campbell Investments, LLC and certain individuals associated with that business (Campbell) objected because (1) the Report found that Dickey’s was not collaterally estopped from litigating the issue of arbitrability under the Development Agreement; and (2) the Report did not expressly determine which claims fell within the Development Agreement. Conversely, Dickey’s Barbecue Restaurants, Inc. (Dickey’s) objected that the Report did not decide (1) whether the Development Agreement delegated questions about the scope of the arbitration clause to the American Arbitration Association (AAA); and (2) whether a certain set of Dickey’s claims fell within the scope of the Development Agreement’s arbitration provision.

The court first held that the Magistrate Judge correctly determined that collateral estoppel did not apply. Campbell asserted that the issue of
the arbitrability of the Development Agreement had been the subject of prior litigation between it and Dickey’s in Utah concerning certain franchise agreements (the Utah Litigation). The Magistrate Judge and the court disagreed, however, concluding that Campbell had presented no evidence that the terms of the Development Agreement had actually been litigated in Utah. Moreover, pertinent portions of the Utah Litigation remained on appeal and, as such, no final judgment had been entered to which collateral estoppel could apply.

The court also concluded that the Magistrate Judge was correct in rejecting the Campbell’s res judicata arguments. The court held that judgment in the Utah Litigation had not become final and, in any event, the Utah Litigation did not raise the question of whether disputes under the Development Agreement required arbitration. As such, there was no existing final judgment of claims before this court.

The court further concluded that Dickey’s had not waived its right to arbitration. Campbell argued that because Dickey’s did not raise the Development Agreement in the Utah Litigation, Dickey’s had waived its right to arbitrate disputes arising under the Development Agreement. The court disagreed, finding that Dickey’s position had been consistent throughout this litigation and that the parties’ disputes under the Development Agreement belong in arbitration.

Finally, both parties objected that the Report did not specify which claims the AAA must arbitrate. The Report recommended that only disputes arising under the Development Agreement should be referred to arbitration. Although both parties were dissatisfied with that result for different reasons, the court overruled the parties’ objections and held that “the scope of the arbitration clause in the Development Agreement is a proper question for the arbitrator.”


In this case, the U.S. District Court for the Northern District of California refused to transfer a dispute between a manufacturer and distributor to Ohio after finding that a forum selection clause contained in an arbitration agreement was not enforceable.

John Fleming (Fleming) is a former distributor for Matco. He brought a putative class action on behalf of himself and other distributors in California claiming that they had been misclassified under California law as independent contractors rather than employees. Matco Tools Corporation (Matco) is a manufacturer of mechanic’s tools and service equipment. It enters into distributorship agreements with individuals who make sales and service calls on prospective and existing customers. Those agreements contain an arbitration provision requiring individual arbitration in Ohio. The arbitration provision further prohibited the distributor from bringing any private attorney general or class claims. Finally, it stated that if the ban on class or private
attorney general claims is deemed invalid, then the arbitration provision is null and void as a whole.

Matco moved to dismiss or transfer the case pursuant to either the forum selection clause within the parties’ agreement or pursuant to 28 U.S.C. §1404(a). The court started its opinion by recognizing the effect that a valid and enforceable forum selection clause has on the section 1404(a) analysis, which is that transfer should occur absent some compelling or countervailing reason. The court then stated that the success of Matco's motion hinged on whether California Business and Professional Code section 20040.5, which voids the selection of non-California forums in franchise agreements, applied. It further recognized that the Federal Arbitration Act (FAA) preempts this limitation in a valid arbitration agreement. Thus, the operative question was whether the arbitration provision in the distributor agreement was valid.

The court explained that the Ninth Circuit Court of Appeals has held that it is impermissible to waive by contract claims under the California Private Attorney General Act (PAGA). PAGA is a statute that allows individuals to bring private attorney general actions to enforce the California labor laws. Under this precedent, the distributor agreement's waiver of PAGA claims was invalid. Because this waiver was invalid, the court then had to decide whether the entire arbitration provision was invalid. It concluded that it was, based on the arbitration provision's own plain language, which said that the requirement to arbitrate is null and void if the waiver of private attorney general actions was deemed invalid. This conclusion led the court to then decide that there was no FAA preemption (as the arbitration provision was invalid). That, in turn, resulted in the court holding that section 20040.5 voided the selection of an Ohio forum.

Matco attempted to escape this result by arguing that the Dormant Commerce Clause invalidates section 20040.5. According to Matco, the provision places a substantial burden on interstate commerce by depriving out-of-state franchisors of the protections of federal law in diversity cases, preventing franchisors from having uniformity in the legal rules that govern their franchise system, and giving California franchisors a competitive advantage. The court rejected these arguments because out-of-state franchisors can still remove their cases to federal court, federal courts are comfortable applying the laws of different states, there was no challenge to the Ohio choice of law provision here, and there was no other evidence of possible prejudice to Matco.

Having determined that the forum selection clause was invalid, the court then addressed Matco's motion to transfer pursuant to the standard private and public interest factors analyzed under §1404(a). The court determined that the private interest factors favored denying the request to transfer. The court highlighted that the relationship between Fleming and Matco had been centered on California. The agreement between the parties was presented to Matco in California, his claims were based on California law, the
action arose based on conduct in California, Fleming had only worked on Matco matters in California, and the majority of the relevant witnesses were in California.

Similarly, the court determined that the public interest factors did not favor transfer either. The court identified a number of public interest factors, including “the administrative difficulties flowing from court congestion; the local interest in having localized controversies decided at home, the interest in having the trial of a diversity case in a forum that is at home with the law that must govern the action; the avoidance of unnecessary problems in conflict of laws, or, in the application of foreign law and the unfairness of burdening citizens in an unrelated forum with jury duty.” The court found that most of these factors were neutral and that the public interest in adjudicating local controversies slightly favored California given that the relationship between the parties was centered on California. Because the public and private interest factors favored California, the court denied the motion to transfer.


In this case, the U.S. District Court for the Western District of Washington held that the claims of a former franchisee against the sole member of a franchisor could proceed despite the franchisor’s various arguments regarding jurisdiction, arbitration, and various contractual provisions.

Defendant Morgan Rothschild (Rothschild) ran Party Princess International (Party Princess) franchise, a franchisor based in California. In October 2015, Party Princess filed paperwork with the state of Washington to register itself as a franchisor. That filing was unsuccessful. During 2015, California residents Robert and Stephanie Taylor (Taylors) contacted Rothschild about potentially opening a Party Princess franchise. In response, Rothschild made various representations about the amount of money the Taylors could earn and how easy it would be for the Taylors to meet the required minimum activities under the franchise agreement. In December 2015, the Taylors signed a franchise agreement with Party Princess.

In January 2016, Party Princess finally successfully registered itself as a franchise with the state of Washington. In February 2016, Rothschild purportedly asked the Taylors to sign a new franchise agreement, claiming that the first agreement had not been effective due to the lack of registration. The record is unclear about whether the Taylors ever signed a new agreement. The Taylors, after allegedly losing over $200,000, filed a complaint in 2017 about Party Princess with the Washington Department of Financial Institutions. In response, Party Princess filed an arbitration against the Taylors in Colorado, purportedly pursuant to an arbitration clause in the franchise agreement. In 2018, the Taylors filed this lawsuit against Rothschild personally. They asserted claims of intentional misrepresentation, negligent misrepresentation, violation of the Washington Consumer Protection Act
premised on a violation of the Washington Franchise Investment Protection Act (FIPA), and unjust enrichment. After the Taylors declared bankruptcy, the Chapter 7 trustee was substituted as the plaintiff. Rothschild advanced a number of arguments in support of his motion to dismiss, none of which was successful.

Rothschild first argued that the court lacked personal jurisdiction over him. The court held that there was no general personal jurisdiction because Rothschild was not domiciled in Washington. The court then turned to specific personal jurisdiction. It first explained that the FIPA specifically states that individuals who sell or attempt to sell franchises in Washington are subject to jurisdiction in that state. There was no real dispute that the franchise at issue was in Washington. Accordingly, the court analyzed whether exercising personal jurisdiction was consistent with due process. The court found that it was, as Rothschild was the sole member of Party Princess; Rothschild personally negotiated with, and sold the franchise to, the Taylors; and Rothschild personally continued to participate in the ongoing relationship between Party Princess and the Taylors after they began operating their franchise in Washington. The court also rejected Rothschild's argument that personal jurisdiction was lacking because the Taylors and Rothschild were located in California when the franchise agreement was signed. The court explained that this fact did not change its analysis as the intent of the negotiations was to establish a Washington business.

Next, Rothschild attempted to argue that various provisions in the franchise agreement precluded the Taylors' tort claims. The court held that Rothschild failed to set forth how the court could analyze contractual defenses on a motion to dismiss and said that if Rothschild wished to raise such defenses, he should do so on by filing a motion for summary judgment that first seeks a ruling showing that there is a valid and enforceable contract and that then seeks a ruling that provisions he cited in the contract bar the Taylors's claims.

Rothschild next argued that the Taylors' claims were raised in the arbitration with Party Princess, and, as such, they must be dismissed under res judicata and collateral estoppel theories. The court rejected this argument too. It explained that res judicata and collateral estoppel are affirmative defenses and can be decided on a motion to dismiss only if the factual allegations and record is undisputed. The record, however, did not contain sufficient information to determine what claims the Taylors had raised in the arbitration. For this reason, the court denied the motion without prejudice on these issues.

Rothschild's final argument was that the Taylors had to arbitrate the claims against him. Rothschild focused most of his briefing on whether the arbitration provision could be enforced against a non-signatory. The court did not discuss the non-signatory issue. Rothschild also focused on whether the venue provision in the arbitration clause was valid. The court noted that while the FIPA prohibited venue provisions outside of Washington, that provision was likely preempted by the Federal Arbitration Act. The court
ultimately denied Rothschild’s arbitration request because the parties had failed to address the most important issue—whether there was an arbitration agreement to enforce in the first place. The court specifically noted that the parties had not clearly briefed this issue and that there was mixed evidence in the record about whether Rothschild violated the FIPA and whether he provided correct documents to the Taylors.

**BANKRUPTCY**


The United States District Court for the Northern District of Texas stayed certain claims and denied stays on other claims related to a pending bankruptcy action for entities related to franchised businesses.

Franchisees of Gigi’s Cupcakes, LLC (Gigi’s) brought suit in federal district court against various entities including Gigi’s, FundCorp, Inc. (FundCorp), Food Business Services, LLC (Food Business), and Gina Butler (Butler) alleging claims including state-law fraudulent transfer, civil conspiracy, violations of the Texas Business Opportunity Act and Deceptive Trade Practices Act, and fraud claims based on alleged material misrepresentations. FundCorp and Food Business did business with Gigi’s and related companies. Butler was one of the original founders of Gigi’s, but no longer had a direct business relationship with Gigi’s as of the filing of the suit.

Gigi’s and several related companies later filed Chapter 11 bankruptcy petitions. The debtor companies’ (Debtors) cases were ordered jointly administered. Following the bankruptcy filing, the district court entered an order staying the district court suit to allow time to determine the effect of the bankruptcy case. Thereafter, FundCorp, Food Business, and Butler filed motions in the district court seeking to extend the stay.

The district court first noted the general rule that the automatic stay in bankruptcy applies only to debtors and not to codebtors, cotortfeasors, or other nondebtor. However, the court also recognized Fifth Circuit law holding that the stay may be extended to nondebtor where “there is such an identity between the debtor and the third-party defendant that the debtor may be said to be the real party defendant and that a judgment against the third-party defendant will in effect be a judgment or finding against the debtor.” Such an exception applies only where a “claim of a formal tie or contractual indemnification ha[s] been made to create an identity of interests between the debtor and nondebtor.”

The court also recognized discretionary stays that can be entered in the interest of justice and for courts to control their dockets. Such discretionary stays are justified “only if, based on a balancing of the parties’ interests, there is a clear inequity to the supplicant who is required to defend while another action remains unresolved and if the order granting a stay can be framed to contain reasonable limits on its duration.”
The court first considered the stay as to FundCorp and Food Business. The court determined that the state-law fraudulent transfer claims were stayed under the automatic stay because the claims alleged injuries derived from harm done to debtor Gigi’s and therefore such claims belonged to the bankruptcy estate. The court found that the injuries alleged by the plaintiff franchisees were general and common to all creditors and thus were subject to the automatic stay. The court also determined that an extension of a discretionary stay was warranted as to the other claims pending against FundCorp and Food Business because such claims were inextricably interwoven with claims against the Debtors. Specifically, to determine FundCorp and Food Business’s liability, the court may be required to resolve factual or legal issues that also affect the Debtors. As such, the court entered an order staying all actions against FundCorp and Food Business.

The court distinguished certain claims against Butler because, unlike FundCorp and Food Business, Butler did not have a present relationship with the Debtors that directly related to the operation of the franchise system. The court found that certain claims sounding in fraud and misrepresentation were based on conduct distinct from the Debtors’ business conduct. As such, the court did not extend a discretionary stay as to those actions against Butler. As to conspiracy claims against Butler, the court did extend the stay for the same reasons as extending the stay for FundCorp and Food Business. That is, the conspiracy claims were tied to the business of the Debtors and would require substantial similar evidence and witnesses to determine liability.

CHOICE OF FORUM


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

CHOICE OF LAW


This case is discussed under the topic heading “Definition of a Franchise.”

CLASS ACTIONS


This case is discussed under the topic heading “Labor and Employment.”


The U.S. District Court for the Northern District of New York rejected attempts by plaintiffs to proceed with a collective action, under the Fair
Labor Standards Act (FLSA), or a class action, under Federal Rule of Civil Procedure 23 (Rule 23), regarding FLSA and state law employment claims against Cellular Sales of New York, LLC (CSNY) and its sole member and parent company Cellular Sales of Knoxville, Inc. (CSK).

CSNY is an authorized Verizon Wireless dealer that markets and sells Verizon Wireless products and services in New York State. CSNY operates its own retail stores, but also contracted with approximately 300 limited liability companies, many of whom were plaintiffs in this lawsuit, to sell Verizon Wireless products and services. These contracts characterized the plaintiffs as independent contractors and required CSNY to pay them commissions based on sales, with the commission amount determined using a variety of factors. Plaintiffs claimed that CSNY and CSK had improperly classified them as independent contractors and, in so doing, had deprived them of benefits under the FLSA and New York state labor laws.

The case previously had been conditionally certified as a collective action under the FLSA. Before the court were dueling motions—the plaintiffs sought to have a class certified under Rule 23. Conversely, the defendants filed a motion to decertify the collective action and opposed the class certification motion.

The court started its analysis with the FLSA, which permits collective actions against parties so long as the named plaintiffs can prove that the opt-in plaintiffs are similarly situated. The court explained that when deciding whether to decertify a conditionally certified class, it assesses the “(1) disparate factual and employment settings of the individual plaintiffs; (2) defenses available to defendants which appear to be individual to each plaintiff; and (3) fairness and procedural considerations.” Here, the court held that each of the three factors weighed in favor of decertification because of the numerous differences among the plaintiffs.

Specifically, discovery had identified “drastic differences” among the plaintiffs as to the degree of control the defendants exercised over them. For example, the plaintiffs had classified and treated their work for the defendants differently for income tax purposes, a fact considered “plainly relevant” to determining independent contractor or employee status. There were also legally significant differences amongst the plaintiffs in how they operated day to day. Some plaintiffs testified that the defendants set their schedule without input, while others testified that the exact opposite occurred. The plaintiffs also had reported vastly different personal investments in equipment, supplies, and advertising—some reporting thousands of dollars spent and others claiming they spent nothing. Similarly, some plaintiffs claimed they had the authority to hire employees, while others had said they could not. There were also differences among the plaintiffs in the level of supervision by the defendants, the ability to set prices, the permanence and duration of the contractual relationship, and the ability to do other work.

The court rejected the plaintiffs’ primary argument that these distinctions were unimportant because there was a common scheme of uniform classification. The court explained that blanket classification decisions and corporate
policies, without more, are not dispositive. Instead, the court concluded that, based on the evidence available, serious material variations would impede reliance on common proof. As a result, the first factor weighed in favor of decertification.

The court next considered whether individualized defenses existed. It held that “where the evidence suggests a wide disparity in the relevant factual circumstances, the ‘individualized differences’ prong of the decertification analysis mirrors the disparate employment settings prong.” Thus, the second factor weighed in favor of decertification. Finally, as to fairness and procedural considerations, the court noted that the differences amongst the plaintiffs would require mini-trials, thus vitiating any benefit of proceeding as a collective action.

The court’s Rule 23 analysis mirrored the FLSA analysis. Specifically, the court held that plaintiffs were unable to show commonality under Federal Rule of Civil Procedure 23(a)(2) or predominance and superiority under Federal Rule of Civil Procedure 23(b)(3) based upon the “material discrepancies” amongst the plaintiffs discussed above.

_Vazquez v. Jan-Pro Franchising Int’l, Inc.,_ Bus. Franchise Guide (CCH) ¶ 16,411, 923 F.3d 575 (9th Cir. 2019)

This case is discussed under the topic heading “Labor and Employment.”

**CONTRACT ISSUES**


The U.S. District Court for the Eastern District of Louisiana partially dismissed a car dealer's lawsuit against a car manufacturer arising from the manufacturer’s failure to secure the proper licensure from the state to sell a specific brand of cars.

Eddie Tourelle’s Northpark Hyundai, LLC (Eddie’s) is a dealer of Hyundai automobiles pursuant to a dealership agreement between it and Hyundai Motor America Corporation (HMA). In 2015, HMA spun off its line of Genesis automobiles, and after doing so Eddie’s signed a purchase agreement with HMA to be eligible to purchase and sell Genesis automobiles. To become eligible, Eddie’s spent over $100,000 to upgrade its facility and train its staff. Eddie’s then sold Genesis branded automobiles to the public. The Louisiana Motor Vehicle Commission (Commission) ultimately determined that HMA could not sell Genesis automobiles because Genesis Motor America LLC (GMA), not HMA, was the manufacturer of Genesis and GMA had not sought approval from the Commission to sell Genesis-branded cars. As a result, the Commission suspended the sale of Genesis cars in Louisiana, and HMA prohibited Eddie’s from making further sales of Genesis cars.
Eddie’s sued GMA and HMA. It alleged that they breached contracts with Eddie’s by (1) failing to obtain the proper license to sell Genesis; (2) removing Eddie’s as an authorized Genesis dealer on its website; (3) suspending the sale of Genesis cars; (4) refusing to make Genesis available until Eddie’s signed a participation agreement; and (5) transferring the Hyundai Equus car model to the Genesis line. Eddie’s also brought claims for negligence, violation of the Louisiana Motor Vehicle Act (LMVA), and violation of the Louisiana Unfair Trade Practices Act (LUTPA). HMA and GMA moved to dismiss the case in full.

The court quickly dismissed the LMVA claim because that act does not contain a private right of action.

Next, the court determined that Eddie’s could not assert breach of contract claims against GMA because there was no contract between it and Eddie’s; the only contracts at issue were between Eddie’s and HMA. The court rejected Eddie’s arguments that GMA was still liable under various non-signatory and alter-ego theories on the ground that the complaint lacked any factual allegations supporting these arguments.

Next, the court ruled that the breach of contract claims related to the suspension of the sale of Genesis vehicles and the transfer of the Equus to the Genesis line failed because both contracts unambiguously gave HMA the right to modify or terminate the sale of products “from time to time.” In making this determination, the court rejected Eddie’s argument that this contractual language violated the LMVA. The court explained that ruling on that argument, in practical effect, creates a private right of action under the LMVA, something that is not allowed. Instead, deciding the legality of the language was left to the Commission.

The court also dismissed Eddie’s contract claim relating to its removal from the website. The relevant contractual provision stated that “HMA agrees to establish and maintain general advertising and promotional programs and will from time to time make sales promotion and campaign materials” available to Eddie’s. The court held that this provision did not obligate HMA to undertake any particular type of advertising or to have a website, let alone to include Eddie’s on it.

Eddie’s argued that each of its remaining breach of contract claims flowed from HMA’s breach of a provision that required it to use “best efforts” to provide Eddie’s with Hyundai products. HMA countered that the provision included the clause “subject to available supply from FACTORY, HMA’s marketing requirements, or any change or discontinuance with respect to any Hyundai Product” and that this clause allowed HMA to change its product offering at any time. The court determined that it was ambiguous what breadth the parties meant to give the “best efforts” provision and therefore refused to dismiss the “best efforts” based contractual claims.

LUTPA requires proof of some kind of immoral, unethical, or unscrupulous behavior. The court determined that the defendants’ failure to obtain a
license was, at worst, grossly negligent. In reaching this decision, the court highlighted that the defendants paid fines assessed by the state against Eddie’s for unauthorized sales of Genesis vehicles, behavior which it concluded was the opposite of unethical or immoral.

The court also dismissed Eddie’s negligence claim. It explained that Eddie’s had not established that the defendants owed Eddie’s any duty other than those found in the contracts with HMA and that contractual duties could not be used to create a tort claim.

Eddie’s also raised additional theories of liability in its opposition papers, including negligent misrepresentation, violation of the Louisiana Automotive Dealer’s Day in Court Act, and detrimental reliance. The court refused to address these theories because they did not appear in the complaint. Eddie’s, however, was granted leave to amend to correct any deficiencies in the complaint (and presumably raise these new legal theories).


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


Addressing a motion to dismiss counterclaims brought by a franchisee against its franchisor alleging implied contract, fraud, negligent misrepresentation, and RICO claims, the U.S. District Court for the District of Maryland granted the motion in part, and dismissed all of the counterclaims with the exception of the negligent misrepresentation claim.

In early 2011, franchisor Kiddie Academy Domestic Franchising, LLC (Kiddie) began discussions with prospective husband and wife franchisees Sumanth Nandagopal and Supiya Sumanth regarding a childcare franchise location. Nandagopal and Sumanth eventually created an entity called Wonder World Learning, LLC (WWL). Nandagopal and Sumanth were not sophisticated investors and had never owned or operated a franchise. From approximately January to June of 2011, Nandagopal and Sumanth had discussions with Kiddie including filling out a questionnaire, visiting Kiddie’s headquarters in Maryland, and completing personal financial statements. The parties also discussed the site selection and construction process. In June 2011, WWL executed a preliminary franchise agreement, which was guaranteed by Nandagopal and Sumanth. WWL made an installment payment of $20,000 toward the total franchise fee of $120,000. Kiddie’s real estate manager thereafter worked with WWL in an attempt to find a suitable location near the home of Nandagopal and Sumanth in San Jose, California. No acceptable sites were located after a two-year search, and Kiddie advised WWL to search for a location near Austin, Texas. WWL located a site in a suburb of Austin and began construction using the Kiddie construction
department. The project ultimately cost significantly more than anticipated. In the meantime, WWL paid Kiddie more than $200,000 in franchise fees and other fees and deposits. In addition, Nandagopal and Sumanth obtained financing from a bank with Kiddie’s assistance. The location opened in August of 2015. Over the next two years, WWL did not perform as expected and, according to WWL, did not receive the support from Kiddie that it believed it would receive.

Kiddie subsequently filed suit against WWL and Nandagopal and Sumanth (the Guarantors) in the U.S. District Court for the District of Maryland, asserting claims of trademark and copyright infringement, breach of contract, and breach of guaranty. Kiddie attached the franchise agreement and the guaranty as exhibits to its complaint. WWL and the Guarantors (the Defendants) filed an answer and a third-party complaint alleging ten counts under federal and Maryland law against Kiddie, as well as third party defendants including a number of Kiddie executives. The Defendants’ claims were intentional misrepresentation, fraud in the inducement, intentional misrepresentation, negligent misrepresentation, defamation per se of a private individual, and four counts relating to alleged violations of the federal Racketeer Influenced and Corrupt Organizations Act (RICO).

Kiddie filed a motion to dismiss the Defendants’ counterclaims pursuant to Federal Rule of Civil Procedure 12(b)(6) for failure to state a claim. The court determined that the third-party defendants were never served and therefore dismissed the counterclaims against such third-party defendants without prejudice. The court substantively took up Kiddie’s motion to dismiss as to the counterclaims brought by the Defendants against Kiddie.

The Defendants’ claims were based on a number of allegations generally relating to the contention that Kiddie intentionally provided the Defendants with incorrect or incomplete information and that Kiddie failed to provide material support once the franchise agreement was executed. The Defendants also alleged that Kiddie defamed Sumanth in meetings among current and former Kiddie employees (which the Defendants did not attend), where Kiddie’s vice president of construction allegedly called Sumanth a liar and made other negative comments.

The court began with an analysis of the standard for considering the motion to dismiss under Rule 12(b)(6), including the fact that a court may consider documents attached to the motion as exhibits that are incorporated into the complaint by reference and that are integral to the complaint. A document is considered integral if its very existence, and not merely the information it contains, gives rise to the legal rights asserted. The court noted that the Defendants did not attach any documents to their amended counterclaim complaint. The court found that the franchise agreement attached to Kiddie’s complaint was integral because it was referred to repeatedly by Kiddie and the Defendants.

The court also addressed the standard for fraud-based claims under Federal Rule of Civil Procedure 9(b) and the requirement that such claims be
pled with particularity, including the “who, what, when, where, and how [present in] the first paragraph of any newspaper story.” The court also found that Maryland law applied based on the presumption of the parties and the absence of any dispute over conflict of law issues.

The court first addressed Kiddie’s assertion that nine out of ten of the Defendants’ counterclaims were barred by the franchise agreement’s one-year contractual limitations period. The court noted that Maryland law provided for a three-year limitations period for the breach of contract and tort claims, while RICO actions were subject to a four-year statute of limitations. The court recognized that limitations can be modified by a provision in an agreement if (1) there is no controlling statute to the contrary; (2) it is reasonable; and (3) it is not subject to other defenses, such as fraud, duress, or misrepresentation. The court noted that the one-year limitation period in the agreement only applied to WWL. The court stated that such a one-sided limitation period would be enforceable under Maryland law, but only if it was supported by a valid justification. The court determined that no such justification had been provided and that, at least at this pre-discovery stage of the litigation, the one-year limitation period would not be applied.

The court also considered the statutory limitation periods, given that the conduct alleged in the counterclaims stretched out over several years. The court considered the discovery rule under Maryland law, which requires the court to consider (1) sufficiency of the actual knowledge to put the claimant on inquiry notice; and (2) sufficiency of the knowledge that would have resulted from a reasonable investigation. Kiddie took the position that the Defendants were on inquiry notice prior to the execution of the franchise agreement, which was more than three years before filing their counterclaims. The court considered each of the various counterclaims and held that under the facts before the court, the Defendants were not put on sufficient notice to time bar their claims.

The court next turned to determining whether the Defendants stated a claim for their various causes of action under Rule 12(b)(6). The court began with the three counts sounding in fraud: intentional misrepresentation, fraud in the inducement, and fraudulent concealment. The court concluded that the Defendants failed to state a claim for each of the causes of action on the grounds that the fundamental basis for the dispute related to breach of the franchise agreement and that the failure to fulfill a promise is a breach of contract, not a fraud. The court also held that the Defendants failed to show that Kiddie intentionally made false statements and that “puffing” and related expressions of opinion are not actionable as fraud. The court thus dismissed the counts sounding in fraud for failure to state a claim.

The court next considered the Defendants’ negligent misrepresentation claim. The court noted that, unlike a fraud claim, a claim based on negligence required a showing of conduct falling below the standard of care owed between the parties. For a negligent misrepresentation claim based upon a promise of future conduct to be actionable, the party making the alleged
misrepresentation must know, at the time the statement is made, that the party does not intend to carry out the promise. The court noted that the Defendants’ allegations were a mix of promises relating to current and future performance or conduct. The court concluded that on the record and, taking the facts in a light most favorable to the Defendants, the Defendants’ allegations were sufficient to state a plausible claim of negligent misrepresentation.

The court then considered the Defendants’ defamation per se count. The court noted that defamation per se is defamation on its face, that is, the words themselves impute the defamatory character. The court also noted that Maryland law recognizes a qualified privilege related to defamation that allows a party to make what otherwise would be defamatory statements if the statements are made to someone who shares a common interest. The privilege may be defeated, but only on a showing of actual malice. The court determined that the alleged defamatory statements were made among Kid-die employees during business meetings and therefore were among parties with a common interest. The court thus dismissed the count on the grounds that the statements were privileged.

The court thereafter considered the Defendants’ detrimental reliance claim. The court characterized the claim as a promissory estoppel claim that, under Maryland law, requires a showing of (1) a clear and definite promise; (2) where the promisor has a reasonable expectation that the offer will induce action or forbearance on the part of the promisee; (3) which does induce actual and reasonable action or forbearance by the promisee; and (4) causes a determinant which can only be avoided by the enforcement of the promise. The court determined that, because the parties were subject to a contract, the detrimental reliance allegations had no basis in contract. The court held that, to the extent the Defendants alleged such reliance, it was relevant to their tort claim for negligent misrepresentation, but that it was not a freestanding tort claim for detrimental reliance/promissory estoppel. Thus, the court dismissed the claim.

The court concluded with an analysis of the RICO claim. The court noted that RICO was not a cause of action to be pled lightly and that it was reserved for conduct whose scope and persistence pose a special threat to social well-being. Moreover, RICO is not aimed at an isolated offender, but it is designed to address a “pattern offender.” The court concluded that the Defendants’ RICO claims failed the continuity and distinctiveness requirements for stating a claim.

The court ultimately concluded that the Defendants stated a claim for negligent misrepresentation but that all of the remaining Defendant counterclaims were dismissed.


Texas Court of Appeals upheld a trial court order granting a preliminary injunction in favor of a beverage franchisor, preventing the franchisee from using unapproved drink mixes and recipes at the franchisee’s location.
Franchisor Eskimo Hut Worldwide, Ltd (Worldwide) operates franchise convenience stores selling frozen daiquiris to go. South Plains Sno, Inc. (South Plains) became a franchisee in 2014 and operated three stores in Lubbock, Texas. The franchise agreement required franchisees to mix the daiquiris according to specific recipes using base mixes and flavors approved by Worldwide. Worldwide did not provide any requirements or guidance regarding whether or not to include alcohol or the type of alcohol to use. The parties appeared to agree that any such requirements relating to alcohol would have been in violation of applicable law.

South Plains filed suit against Worldwide in Texas state court alleging breaches of the franchise agreement. Worldwide filed a counterclaim alleging that South Plains breached the agreement. Worldwide sought a preliminary injunction preventing South Plains from selling daiquiris using non-approved base mix or otherwise preparing daiquiris in a manner different than the specifications contained in the Worldwide operating manual. The trial court granted the motion for preliminary injunction. South Plains appealed to the Texas Court of Appeals.

The court noted that, to obtain a preliminary injunction, Worldwide was required to plead and prove (1) a cause of action against South Plains; (2) a probable right of recovery; and (3) a probable, imminent, and irreparable injury in the interim. The court reviewed the evidence to address whether Worldwide established a probable right to recovery, including the fact that a South Plains representative admitted that South Plains used two ounces of base mix per batch rather than the three gallons required by Worldwide. South Plains countered by asserting that flavor consistency was not actually possible because South Plains was allowed to add whatever type of alcohol it desired. The court of appeals noted contrary testimony by Worldwide's president that the base mix provided the flavor and consistency and that alcohol did not change that. The court also found that South Plains’ argument was unsupported and that Texas law relating to alcohol sales required Worldwide to surrender control. On the record before the court, the court held that Worldwide had demonstrated a probable right to recovery.

On the final element, the court considered the testimony of Worldwide’s president that if the unapproved flavors used by South Plains turned off customers, the customers might never visit another Eskimo Hut location. The court also noted the fact that the franchise agreement included a provision that Worldwide would have no remedy at law if a franchisee failed to comply with such standards and that Worldwide would be entitled to injunctive relief. The court stated that it could find no case holding that such a contractual provision alone would entitle a party to injunctive relief. However, the court of appeals found that the provision could have provided some support to the trial court to grant the injunction. Moreover, the court of appeals held that the trial court was entitled to judge the credibility of witnesses on the issue and that such decision would not be overturned on the record before the court. As
such, the court of appeals found that Worldwide had established the elements for a preliminary injunction and upheld the trial court.

DEFINITION OF A FRANCHISE


The U.S. District Court for the Eastern District of Missouri largely granted a Federal Rule of Civil Procedure 12(b)(6) motion to dismiss claims brought by a wholesaler of alcoholic beverages against the manufacturer of such beverages and competing wholesalers, holding that only the claims against the manufacturer for recoupment and unjust enrichment had been sufficiently pleaded to state a claim for relief. The court also dismissed claims against one defendant due to lack of personal jurisdiction.

As pleaded in its complaint, plaintiff Major Brands, Inc. (Major Brands) is a wholesaler of intoxicating liquors and is licensed to do so under Missouri law. Defendants Mast-Jägermeister U.S., Inc. and Mast-Jägermeister U.S. Holding, Inc. (collectively, Jägermeister) manufacture intoxicating liquor that is distributed in Missouri through duly licensed wholesalers. The remaining defendants (Southern) are also wholesalers licensed to distribute intoxicating liquor in Missouri and are competitors of Major Brands. Major Brands alleged that it had a long-standing distribution relationship with Jägermeister (the Distribution Agreement), and made significant expenditures of time, money, and human resources pursuant to that relationship.

On February 13, 2018, Jägermeister told Major Brands that Jägermeister was terminating the Distribution Agreement because Jägermeister wanted to consolidate its distribution nationally with Southern. Believing such termination was unlawful, Major Brands brought suit in Missouri state court, but the case was ultimately removed to federal court. Major Brands alleged claims against Jägermeister for a declaratory judgment, claiming that Jägermeister’s termination was unlawful under Missouri’s franchise law, and also alleging violations of Missouri’s Merchandising Practices Act, and claim for breach of contract, breach of the covenant of good faith and fair dealing, recoupment, unjust enrichment, and civil conspiracy. Major Brands also alleged claims against Southern for tortious interference with contract. The defendants moved to dismiss Major Brands’ complaint for failure to state a claim and, with the exception of the recoupment and unjust enrichment claims against Jägermeister, the court agreed with the defendants and dismissed the claims.

As to the declaratory judgment claim and the Missouri franchise law claim, Major Brands alleged that Jägermeister's purported termination was not supported by “good cause” and therefore ran afoul of Missouri’s franchise law. In dismissing these claims, the court analyzed the Missouri Merchandising Act’s definition of “franchise,” Mo. Rev. Stat. §407.400(1), and Missouri Supreme Court and Eighth Circuit decisions interpreting it, and concluded that the
statute’s “general definition” of a franchise “indeed applies to franchise relationships within the liquor industry the same as it applies to all other businesses.” That “general definition” provides that a franchise is a written or oral arrangement for a definite or indefinite period, in which a person grants to another person a license to use a trade name, service mark, or related characteristic, and in which there is a community of interest in the marketing of goods or services at wholesale, retail, by lease, agreement, or otherwise.” Given the applicability of this definition, the court found that the complaint was deficient because it failed to allege facts about any trademark license from Jägermeister and any “community of interest” with Jägermeister. And, absent allegations of a franchise, the “good cause” requirement was held not to apply to Jägermeister’s termination efforts.

Regarding the breach of contract claim, the court first held that the Distribution Agreement was “presumably an oral agreement,” but was not a contract for the sale of goods and thus did not run afoul of the statute of frauds. However, Major Brands’ allegations about how the Distribution Agreement had been breached were ambiguous and therefore too indefinite to support an independent breach of contract claim. In particular, Major Brands alleged that under Missouri’s franchise law “and as part of the Distribution Agreement,” Jägermeister could only terminate for good cause. But it was unclear whether the Distribution Agreement itself independently contained an obligation to terminate only for “good cause,” or whether such a requirement was being extrapolated from the Missouri franchise law. Without such clarity, the court held that the complaint did not state a separate claim for breach of contract. The court also concluded that Major Brands’ claim for breach of the covenant of good faith and fair dealing failed for similar reasons.

With respect to the tortious interference claims, which alleged that Jägermeister interfered with Major Brands’ business expectancy in the distribution of Jägermeister’s products to retailers, the court held that the complaint was similarly defective. In particular, the complaint only stated that there was a “valid business expectancy in the distribution of [Jägermeister’s] brand,” but did not allege any further facts in that regard. It was therefore “impossible to ascertain whether [Major Brands] is relying solely on the Distribution Agreement as the basis of the business expectancy, in which case [Major Brands] cannot state a claim, or whether [Major Brands] had some other business relationship with the retailers such that a valid business expectancy exists.”

In addition, given the dismissal of the tortious interference claim and the franchise claim, the civil conspiracy claim also failed. And given these dismissals, the tortious interference claim against Southern failed as well.

The court did spare two of Major Brands’ claims: one for recoupment and one for unjust enrichment. Those equitable claims survived because the complaint’s allegations put Jägermeister on sufficient notice that Major Brands had expended substantial money, time, and labor promoting Jägermeister’s brands and that it would be inequitable for Jägermeister to retain the benefit of those efforts without compensating Major Brands. In addition,
the court granted Major Brands leave to file an amended pleading to address the defects in its original claims.

Finally, the court held that Defendant Mast-Jägermeister U.S. Holding Inc. was not subject to personal jurisdiction. In particular, the record was “completely silent” as to any contacts that this entity had with Missouri. The most that had been alleged was that this defendant had conspired with the others. However, because the conspiracy count had been dismissed, the court did not need to address that potential basis for jurisdiction and dismissed the claims in their entireties against this defendant for lack of personal jurisdiction.

The U.S. District Court for the District of Minnesota granted summary judgment in favor of the defendants, dismissing, as a matter of law, claims alleging breach of a nondisclosure agreement, tortious interference, violations of Minnesota’s Franchise Act and Termination of Sales Representative Act, and failure to pay earned commissions. These claims had been brought by a party held to be an independent sales representative, rather than a franchisee, who alleged, among other things, that the termination of his sales representative agreement was without “good cause” and therefore unlawful.

On January 1, 2001, plaintiff Engineered Sales Co. (ESC) entered into an exclusive sales representative agreement (the Agreement) with defendant Endress + Hauser Inc. (E+H), by which E+H appointed ESC as E+H’s exclusive sales representative for Minnesota, North Dakota, South Dakota, and portions of Wisconsin. The Agreement identified ESC as an “independent contractor” and provided that either party could terminate the Agreement “with or without good cause” upon thirty days’ written notice. Over the course of several years, the parties modified certain aspects of the Agreement, with the final modification occurring in September 2010.

In 2013, E+H began consolidating its sales representatives throughout the country, resulting in ESC discussing the prospect of merging with defendant Miller Mechanical Specialties Inc. (MMS). For various reasons, E+H favored such a merger and became involved in the merger negotiations between ESC and MMS. E+H and MMS signed a non-disclosure agreement with E+H (the NDA) as part of those talks. Apparently unbeknownst to ESC, however, E+H began to put its thumb on the scale, preferring an arrangement by which MMS would acquire ESC. E+H directed the negotiations accordingly, telling ESC that E+H would simply terminate the Agreement if an acceptable deal could not be reached. As negotiations broke down, on June 16, 2015, E+H terminated the Agreement effective July 17, 2015. E+H then appointed MMS as E+H’s sales representative in ESC’s former territory. In addition, and some eighteen months later, a third party who was well known in the industry (MSA), also replaced ESC with MMS as its sales representative, with ESC alleging that E+H had some hand in that occurrence.
Fed up, on July 12, 2017, ESC brought suit against E+H and MMS and, following discovery, E+H and MMS moved for summary judgment. ESC also moved for partial summary judgment. The court granted E+H and MMS’s motion, denied ESC’s motion, and dismissed the action with prejudice.

With regard to ESC’s claim that E+H and MMS breached the NDA, the court found that ESC had failed to cite any actual facts supporting that claim. For MMS, the court found that there was no evidence that MMS used ESC’s confidential sales data to target MSA. With respect to E+H, the court held that MSA was a well-known market leader, and the value of a relationship with MSA was obvious even without using any of ESC’s confidential sales data. The court therefore dismissed this claim as a matter of law. This analysis also doomed ESC’s tortious interference claim, which was premised on E+H and MMS using ESC’s confidential information.

ESC also claimed that it was E+H’s franchisee and, therefore, could not be terminated without “good cause” under the Minnesota Franchise Act, Minn. Stat. § 80C.14, subdiv. 3(b). E+H responded that ESC was not a franchisee and could be terminated for any reason on thirty days’ written notice. The court agreed with E+H. In particular, the court held that ESC did not pay franchise fees to E+H, which is one of the elements necessary to establish a franchise under Minnesota law. In addition, the court held that the Agreement itself undercut ESC’s argument by identifying ESC as an “independent sales representative” and an “independent contractor,” rather than a franchisee. “Had the parties wanted to create a franchise relationship, they could easily have done so.”

Finally, ESC alleged that E+H violated the Minnesota Termination of Sales Representative Act, Minn. Stat. § 325E.37, subdiv. 2(a) (the MTSRA). The MTSRA prohibits a manufacturer from terminating a sales representative without “good cause” and requires ninety days’ written notice and a sixty-day cure period. E+H argued that the MTSRA did not apply because the Agreement specified that it was governed by Indiana law. However, effective August 1, 2014, the Minnesota legislature had amended the MTSRA to prohibit choice-of-law provisions that specify a state other than Minnesota, but applied this prohibition only to sales representative agreements “entered into, renewed or amended on or after that date.” Although ESC argued that E+H had “renewed” the Agreement by soliciting orders after August 1, 2014, and asserted that 1991 amendments to other parts of the MTSRA supported this interpretation, the court disagreed. The court concluded that because the Agreement did not have an expiration date, it could not be “renewed” in the commonly understood meaning of that word. The court therefore held that the 2014 amendments to the MTSRA did not apply to the Agreement and that the Indiana choice-of-law provision was valid and entitled E+H to summary judgment. And, because ESC’s claim under the MTSRA failed, its claim for unpaid commissions—which were premised on E+H’s violations of the MTSRA—also failed, as a matter of law.
FRAUD


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


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


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

INJUNCTIVE RELIEF


This case is discussed under the topic heading “Trade Secrets.”


In this case, the U.S. District Court for the District of Minnesota rejected a licensee’s request for a temporary restraining order and preliminary injunction in response to the threatened termination of the license agreement by the licensor.

Plaintiff Izabella-MHC-MF, LLC (Izabella) operates a Radisson hotel in Wisconsin pursuant to a license agreement with Defendant Radisson Hotels International, Inc. (Radisson). In January 2019, Radisson sent Izabella a letter stating that Izabella was in default of the license agreement for performing renovations at the hotel without Radisson’s approval. The letter demanded that renovations cease, and, if they did not, Radisson would terminate the agreement on May 1, 2019. Izabella countered that it had not conducted renovations; it had merely changed the carpet, drapes, and lamps in two rooms. Radisson alleged that these changes were done to create prototype show rooms in preparation for conversion of the hotel to a non-Radisson branded hotel in June 2019.

On April 30, 2019, Izabella filed suit, alleging that Radisson’s threatened termination violated the Wisconsin Fair Dealership Law (WFDL) and amounted to an anticipatory breach of contract. Izabella sought injunctive relief the same day. Radisson terminated the license on May 1, 2019. The court determined that Izabella was not entitled to injunctive relief because it was not able to make the required showing of irreparable harm.
Izabella had relied on a provision in the WFDL that said a violation of the act causes a licensee irreparable harm. The court, however, explained that this statutory presumption was rebuttable and held that Radisson had successfully rebutted the presumption for three reasons.

First, Izabella argued that it would be irreparably harmed by termination as it would cause a loss of bookings at the hotel and an impairment in its ability to attract customers. Radisson countered, and the court agreed, that such losses were nothing more than lost profits, which are compensable with money damages. The court specifically pointed to the fact that Izabella had provided an estimate of its monthly losses.

Second, Izabella tried to show irreparable harm by pointing to a loss of goodwill and reputation if it could not use the Radisson brand. The court, however, said that the goodwill of the Radisson brand belongs to Radisson, the licensor, not Izabella, the licensee. As such, Izabella had failed to show any potential irreparable harm to goodwill it actually owned.

Finally, Radisson argued, and the court again agreed, that any harm Izabella would suffer was self-inflicted and temporary. It offered evidence, in the form of photographs, documents, and employee testimony, that Izabella was planning on converting to a non-Radisson hotel in the near future and that the renovations, which started the dispute, were part of that plan. This fact further undermined the statutory assumption of irreparable harm.


**JURISDICTION**


**LABOR AND EMPLOYMENT**

*DiFlavis v. Choice Hotels Int’l, Inc.*, Bus. Franchise Guide (CCH) ¶ 16,400, 2019 WL 1505860 (E.D. Pa. Apr. 5, 2019) The U.S. District court for the Western District of Pennsylvania refused to dismiss a lawsuit brought by an employee of a franchisee against the franchisor, noting that the complaint pleaded sufficient facts to establish that the franchisor might be the joint employer of the employee given the control retained over the conditions of employment.
Gina DiFlavis (DiFlavis) was a housekeeper at the Clarion Hotel & Conference Center in Essington, Pennsylvania. DiFlavis was employed by the owner and operator of the hotel, franchisee Rama Construction Company, Inc. (Rama). DiFlavis and related workers were assigned sixteen rooms to clean each day. She was paid $9.00 an hour for her first eight hours of work, plus $5.00 for each room cleaned beyond the assigned sixteen rooms. DiFlavis alleged that it often took longer than eight hours to clean the sixteen rooms and that she was not paid overtime for her work. DiFlavis brought a collective action under the Fair Labor Standards Act and the Pennsylvania Minimum Wage Act against franchisor Choice Hotels International, Inc. (Choice) asserting that Choice was her joint employer. Choice filed a motion to dismiss under Federal Rule of Civil Procedure 12(b)(6), or a motion to strike under Rule 12(f), asserting that DiFlavis had failed to sufficiently allege that Choice was a joint employer and alternatively that the collective action claims should be stricken or limited to the location where DiFlavis worked because that was the only location where Choice and Rama were alleged to be joint employers.

As to the joint employer allegations, the court noted that the franchise agreement stated that Rama was solely responsible for exercising control over the hotel. The court also noted that under applicable federal law, a joint employment relationship can exist where the employers are not “completely associated” with respect to employment of individuals. In determining whether an employer-employee relationship existed, the court considered the following factors: (1) authority to hire and fire employees; (2) authority to promulgate work rules and assignments, and set conditions of employment, including compensation, benefits, and hours; (3) day-to-day supervision, including employee discipline; and (4) control of employee records, including payroll, insurance, taxes, and the like.

The court found that DiFlavis made sufficient allegations that Choice exercised significant control over all aspects of the hotel. Moreover, the court found no support for Choice’s argument that the fact that terms of the franchise agreement—which stated that Rama was solely in charge of personnel issues—was dispositive. In addition, Choice argued that DiFlavis was required to demonstrate that Choice—rather than Rama—was DiFlavis’s “primary” employer. The court disagreed, holding that joint employment liability can exist even where one party is not the primary employer. The court further refused to strike DiFlavis’s pleading under Rule 12(f) on the grounds that striking a pleading is a dramatic remedy appropriate only where the allegations have no possible relation to the controversy and may cause prejudice to one of the parties. As to the collective action allegations, the court stated that such pleading will be stricken only in the rare circumstance where the complaint itself demonstrates that the requirements for such an action cannot be met. The court noted in particular that, while DiFlavis was privy only to the franchise agreement at the Rama hotel, it was not unlikely that other franchise agreements were similar and led to similar issues. As such, the court refused to dismiss the complaint.
This case is discussed under the topic heading “Arbitration.”

This case is discussed under the topic heading “Vicarious Liability.”

This case is discussed under the topic heading “Class Actions.”

Vazquez v. Jan-Pro Franchising Int'l, Inc., Bus. Franchise Guide (CCH) ¶16,411, 923 F.3d 575 (9th Cir. 2019)  
This case involved a putative class action brought by California resident franchisees (the Plaintiffs) of Jan-Pro International Franchising, Inc. (Jan-Pro). It involved more than a decade of procedural maneuvering by other plaintiffs in other courts across the country. Ultimately, taking the lengthy procedural history into account, the Ninth Circuit remanded to the district court for further proceedings consistent with its opinion.

In 2008, Giovani Depianti and a number of other plaintiffs filed suit in the U.S. District Court for the District of Massachusetts against Jan-Pro, asserting that Jan-Pro’s “three-tier” franchising model was developed to allow Jan-Pro to avoid paying its janitor franchisees minimum wages and overtime compensation. Over the following months, additional franchisee plaintiffs joined the case. The Massachusetts district court chose Depianti’s claim as a test case, severed the claims of plaintiffs from California, and sent the California plaintiffs’ cases to the U.S. District Court for the Northern District of California.

The Massachusetts district court did not ultimately rule on the merits, but did develop a factual record, which came into play as the California case was being litigated. Under the Jan-Pro system, Jan-Pro contracted with certain “master franchisees” who received the exclusive rights to use the Jan-Pro logo. The master franchisees then sold business plans to “unit franchisees” who would perform the janitorial services. Jan-Pro did not contract with the unit franchisees, but did maintain certain controls including inspecting premises serviced by a unit franchisee to ensure that Jan-Pro’s standards were being met. In addition, the agreement between Jan-Pro and the master franchisees gave Jan-Pro a number of rights including: (1) authority to enforce any agreement between a master franchisee and a unit franchisee; (2) the right to assume a master franchise agreement if the master franchisee terminates or defaults; (3) naming Jan-Pro as a third party beneficiary to the unit franchisee agreement; and (4) Jan-Pro’s right to unilaterally promulgate policies and procedures binding on both the master franchisee and the unit franchisees. All agreements among the parties described the unit franchisee as an independent contractor and disclaimed any employment relationship.
Depianti contracted with a Jan-Pro master franchisee called Bradley Marketing Enterprises, Inc. (BME). Depianti argued that his status as a unit franchisee was a “farce” and that he was in reality a direct employee of Jan-Pro. Jan-Pro argued that Depianti was an independent contractor under the “ABC test” as set forth in a Massachusetts statute. Under the test, an individual is considered an employee unless each of the following elements is met: (1) the individual is free from control and direction in connection with the performance of the service, both under his contract for performance of service and in fact; (2) the service is performed outside the usual course of business and the employer; and (3) the individual is customarily engaged in an independently established trade, occupation, profession, or business of the same nature as that involved in the service performed. The employer bears the burden of proof on the elements.

Both sides moved for summary judgment in the Massachusetts district court case. The district court certified a question to the Massachusetts Supreme Judicial Court (SJC) on whether a defendant may be liable for employee misclassification under Massachusetts law where there was no contract of employment between the plaintiff and the defendant. The SJC answered yes, but took no position on the specific facts of the case.

In the meantime, Jan-Pro (a Georgia corporation) filed an action in Georgia state court against Depianti seeking a declaratory judgment that no employment relationship existed between Jan-Pro and Depianti under the ABC test and that Jan-Pro therefore was not liable to Depianti in tort or contract. Jan-Pro obtained a final judgment from the Georgia Court of Appeals to that effect.

The Georgia decision became final before the Massachusetts district court took action on the SJC’s answer to its certified question. Thereafter, upon Jan-Pro’s request, the Massachusetts district court dismissed the case on res judicata grounds, finding that the court was obligated to accord full faith and credit to the Georgia decision. The First Circuit affirmed.

Jan-Pro thereafter argued that res judicata and the law of the case in the Depianti case precluded the Plaintiffs from moving forward in their suit against Jan-Pro pending in the U.S. District Court for the Northern District of California. The district court analyzed the issues in the context of the standards set forth in two cases, Patterson v. Domino’s Pizza, LLC, 333 P.3d 723 (Cal. 2014), and Martinez v. Combs, 231 P.3d 259 (Cal. 2010). The Patterson court, in addressing allegations of sexual harassment by a supervisor for a franchisee, held that a franchisor could not be held liable unless the franchisor “entered the arena” of overseeing the franchisee’s day-to-day operations. The Martinez case, in contrast, was a wage and hour matter and set forth three alternative definitions of what it means to employ someone: (1) to exercise control over the wages, hours, or working condition; or (2) to suffer or permit to work; or (3) to engage, thereby creating a common law employment relationship. The district court found no binding authority on the issue and therefore applied “the Martinez standard with the gloss
of Patterson.” That is, the court merged the Martinez “exercise of control” prong with the Patterson “right to control” prong. The court thus concluded that the Plaintiffs had failed to raise a genuine issue of disputed fact about whether Jan-Pro directly or indirectly exercised control over their activities or whether Jan-Pro had the right to control unit franchisees’ day-to-day activities. The district court also analyzed the “suffer or permit” prong, finding in Jan-Pro’s favor on the grounds that Jan-Pro lacked the authority to stop the Plaintiff unit franchisees from working. The district court thus granted summary judgment in favor of Jan-Pro.

Following the district court’s decision, the California Supreme Court issued a decision, Dynamex Ops. W. Inc. v. Superior Court, 416 P.3d 1 (Cal. 2018), wherein the court adopted the ABC test for determining whether an employee is an independent contractor. The Plaintiffs appealed the district court’s decision to the Ninth Circuit. The Ninth Circuit addressed a number of different issues on appeal. First, the court held that the Massachusetts district court and First Circuit decisions had neither res judicata nor law of the case preclusive effect on the Plaintiffs’ case for a number of reasons including: (1) the Plaintiffs were not a party to the prior action; (2) there was not a showing that the Plaintiffs’ interests sufficiently aligned with the interests of parties in the prior action; and (3) there was no showing that the Plaintiffs were adequately represented by a party to the prior action. The Ninth Circuit also found that binding the Plaintiffs to the prior action would not accord with due process and common-law principles of fairness because the Massachusetts district court did not certify a class action, but rather severed the Plaintiffs so that they could separately have their own day in court.

The Plaintiffs cited to the Dynamex case in support of their arguments on appeal, and Jan-Pro responded that the Dynamex holding should not be applied retroactively. The Ninth Circuit noted the general rule that, while statutes act prospectively, judicial decisions operate retroactively. There can be an exception to that general rule when a judicial decision changes a settled rule upon which the parties relied. The Ninth Circuit concluded that Dynamex was a clarification of, rather than a departure from, existing law and also noted no indication from the California Supreme Court that the decision should be applied only prospectively. The Ninth Circuit also found that retroactive application was consistent with due process. Therefore, the Ninth Circuit rejected Jan-Pro’s argument that Dynamex should not be considered.

The Ninth Circuit determined that the district court had no opportunity to consider whether the Plaintiffs were employees under the fact-intensive Dynamex standard. The Ninth Circuit remanded the matter to the district court to consider the question “with the benefit of a more developed record.” However, the Ninth Circuit provided the district court with several pages of “observations and guidance” for the court’s use on remand. First, the Ninth Circuit stated that the district court should consider all three prongs of the ABC test and “may wish to consider authorities from other
jurisdictions that apply the test.” Next, the Ninth Circuit stated that there should be no “Patterson gloss” to the application of the ABC test. The Ninth Circuit noted that Patterson involved a tort and that there was no reason the same test should be applied in tort cases as in wage and hour cases. The Ninth Circuit also took note of other decisions applying the ABC test in the context of three-tier franchise structures similar to Jan-Pro. In particular, the court noted that prong B of the test was most susceptible to summary judgment because prongs A and C were likely to require the need for further factual development. The court noted other decisions that have asked three questions that the district court can use in determining whether prong B has been met: (1) Are unit franchisees necessary to Jan-Pro’s business; (2) Do unit franchisees continuously work in the Jan-Pro business system; and (3) Does Jan-Pro hold itself out as a cleaning business? As to the third question, the Ninth Circuit specifically refuted any argument that Jan-Pro was in the franchising business rather than the cleaning business. The court quoted language from the Massachusetts district court that franchising is not a business, but rather it is a “model as a means of distributing the goods or services to the final end user without acquiring significant distribution costs.” The Ninth Circuit further quoted language from the decision that attempts to characterize franchising as a business itself were akin to descriptions of a “modified Ponzi scheme”: that is, “a company that does not earn money from the sale of goods or services, but from taking in more money from unwitting franchisees to make payments to previous franchisees.”

NON-COMPETE AGREEMENTS

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

This case is discussed under the topic heading “Trade Secrets.”

STATUTORY CLAIMS

This case is discussed under the topic heading “Labor and Employment.”

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

This case is discussed under the topic heading “Definition of a Franchise.”


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


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


This case is discussed under the topic heading “Labor and Employment.”

**TERMINATION AND NONRENEWAL**


The U.S. Court of Appeals for the Sixth Circuit affirmed the district court’s grant of summary judgment dismissing counterclaims for wrongful termination, malicious litigation, and breach of a right of first refusal brought by a licensee of the Buffalo Wild Wings franchise system.

In 1990, the predecessor of plaintiff Buffalo Wild Wings, Inc. (BWW), entered into a licensing agreement (the Licensing Agreement) with defendant BW-3 Akron, Inc. (BW-3 Akron). The Licensing Agreement gave BW-3 the right to operate a Buffalo Wild Wings restaurant in Akron, Ohio—including the use of BWW’s trademarks and the Buffalo Wild Wings “system”—and a right of first refusal for the opening of any Buffalo Wild Wings restaurant in five additional Ohio counties. Thereafter, BWW licensed others to open additional restaurants in some of those counties, and, between 1992 and 1997, one of the owners of BW-3 Akron complained to his son that BWW had not honored BW-3 Akron’s rights of first refusal.

In 2003, the parties had a dispute about whether a remodeling of the Akron store was necessary, in order to upgrade the Akron store to BWW’s so-called “Stadia” design. A lawsuit was filed but ultimately settled. Ten years later, in 2013, the parties engaged in negotiations for BWW to buy out BW-3 Akron. During those discussions, BWW again raised the need for the Akron store to be upgraded to BWW’s current Stadia design standards. BW-3 Akron subsequently brought suit in Ohio state court, alleging a breach of the right of first refusal. Talks continued, however, including a walkthrough of the Akron store, to determine what would be needed to upgrade that store to the Stadia design. Following the walkthrough, BW-3 Akron advised BWW that BW-3 Akron did not intend to remodel. BWW
therefore sent BW-3 Akron a notice of default on April 1, 2016, advising that if BW-3 did not take steps to upgrade the Akron store within thirty days, BWW would terminate the Licensing Agreement.

On May 17, 2016, BWW filed suit in federal court, alleging violations of the Lanham Act and seeking a declaratory judgment that BWW could terminate the Licensing Agreement due to BW-3 Akron’s defaults. On that same day, BWW also sent a letter to BW-3 Akron saying that BWW would hold termination in abeyance pending the outcome of the lawsuit. Approximately one month later, BW-3 Akron closed the Akron store and re-branded it as a new restaurant called “Gridiron Grill.” BWW notified BW-3 Akron that it considered this re-branding to constitute a separate default under the Licensing Agreement and that BWW would terminate the Licensing Agreement if BW-3 Akron did not re-open the Akron store as a Buffalo Wild Wings restaurant within thirty days. In response, BW-3 asserted counterclaims for wrongfull termination, malicious litigation, and breach of the right of first refusal.

On cross-motions for summary judgment, the district court granted BWW’s motion, dismissed BW-3 Akron’s counterclaims, and denied BW-3 Akron’s summary judgment motion regarding BWW’s affirmative claims. BWW subsequently dismissed its affirmative claims, and BW-3 Akron appealed the grant of summary judgment dismissing its counterclaims.

With only BW-3 Akron’s counterclaims before it, the Sixth Circuit affirmed. Regarding BW-3 Akron’s wrongful termination counterclaim, the Sixth Circuit held that BWW had not actually terminated the Licensing Agreement, because the May 17, 2016, letter stayed actual termination pending resolution of BWW’s lawsuit. The court also rejected BW-3 Akron’s argument that BWW had constructively terminated the Licensing Agreement, reasoning that BWW had taken no action that “essentially destroy[ed] the viability of the contract.” Additionally, the Sixth Circuit held, as a matter of law, that BW-3 Akron had voluntarily abandoned the Licensing Agreement by closing the Akron store, removing all of BWW’s marks, and re-opening as “Gridiron Grill.”

Concerning BW-3 Akron’s malicious litigation counterclaim, the Sixth Circuit opined that this counterclaim could be sustained only if BWW’s affirmative claims were “objectively baseless.” The Sixth Circuit held that they were not. BWW’s declaratory judgment claim was not objectively baseless because the Licensing Agreement was “remotely susceptible” to BWW’s interpretation that BW-3 Akron was required to adopt the Stadia design layout and that BW-3 Akron’s refusal to do so was a breach of the Licensing Agreement. Similarly, with respect to BWW’s Lanham Act claims, the court held that BWW “had at least a colorable argument that, by refusing to update the Akron restaurant in order to provide a customer experience consistent with the BWW brand, BW-3 Akron used BWW’s marks in a way not authorized under the Licensing Agreement.”

Finally, the Sixth Circuit affirmed dismissal of BW-3 Akron’s counterclaim asserting a breach of the right of first refusal. BW-3 Akron did not
appeal the district court’s ruling that the statute of limitations barred this counterclaim except as to two stores, one that opened in 2000 and one that opened in 2004. The Sixth Circuit held, however, that BW-3 Akron had adduced no affirmative evidence to support its counterclaim that the right of first refusal had been breached. The only evidence submitted was hearsay testimony that one of BW-3 Akron’s owners complained to his son about the matter between 1992 and 1997, which pre-dated the opening of the stores in question. Consequently, the Sixth Circuit concluded that the district court did not err in finding that BW-3 Akron failed to establish any facts to support an essential element of this counterclaim.


This case is discussed under the topic heading “Definition of a Franchise.”


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


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


The Supreme Court of New Hampshire held that the 180-day look-back aspect of the New Hampshire Motor Vehicle Dealer Law’s termination provisions was triggered by the breach that actually gave rise to the dealership’s termination and that continuing breaches of a dealership agreement act to re-start the 180-day clock.

In December 2007, TS&A Motors, LLC d/b/a Kia of Somersworth (Somersworth) and Kia Motors America, Inc. (Kia) entered into an automobile dealership agreement (the Agreement). Among other obligations, the Agreement required Somersworth to employ certain parts and service personnel. Somersworth had great difficulty complying with this obligation. Indeed, between March 2011 and March 2012, Kia sent Somersworth a series of letters outlining Somersworth’s perceived staffing and training deficiencies, which included deficiencies occurring in 2009 and 2010 and thereafter. Kia management worked with Somersworth to try to remedy these staffing and training deficiencies, but to no avail. Somersworth was violating the Agreement’s obligations in this regard “on an almost constant basis.”

By November 6, 2014, Kia had had enough, and sent Somersworth formal notice of Somersworth’s breach of the Agreement due to Somersworth’s
failure to employ minimally adequate parts and service staff. This letter gave Somersworth a sixty-day period within which to cure these staffing breaches. When Somersworth did not do so, on February 23, 2015, Kia notified Somersworth that, effective ninety days later, the Agreement would terminate.

Pursuant to New Hampshire law, Somersworth protested the termination before the New Hampshire Motor Vehicle Industry Board (the Board). Somersworth claimed that the tight labor market for automobile service workers in that area made it unable to comply with the Agreement’s staffing requirements and, consequently, that there was not “good cause” for the termination as required by New Hampshire statutory law, specifically, N.H. Rev. Stat. Ann. § 357-C:7, I(c). The Board denied Somersworth’s protest. Somersworth then sought a rehearing before the Board, arguing that Kia’s termination letter did not come within 180 days after Kia first learned of Somersworth’s staffing issues, as required by N.H. Rev. Stat. Ann. § 357-C:7, II(a). The Board rejected this argument as well, finding that Kia’s notice was proper because of the continuing nature of Somersworth’s staffing problems. Somersworth appealed the Board’s decision to superior court, which affirmed the Board. Somersworth then appealed to the Supreme Court of New Hampshire.

The Supreme Court of New Hampshire, interpreting the statute, also affirmed. The court credited Kia’s argument that the 180-day requirement is triggered by “the specific failure on which the termination was based”—which in this case occurred between October 2014 and February 2015—and not by Somersworth’s earlier staffing issues. The court held that “when read in its entirety, the 180-day look-back provision mandates that a manufacturer first acquire knowledge of the failure on which its termination is based no more than 180 days prior to the date on which it provides the dealer with notice of the termination” (emphasis in original). Moreover, the court held that “each day a dealer is in breach is a new ‘failure’ on which a manufacturer’s termination may be based.” To support its holding, the court also reviewed cases and statutes from other states, specifically Alabama (which has similar automobile dealership termination provisions), as well as cases interpreting the federal Petroleum Marketing Practices Act (which has similar look-back termination requirements and which had been interpreted in similar fashion on this very issue).

Finally, the court held that its statutory interpretation would further the statute’s purpose and that Somersworth’s interpretation would undermine that purpose and lead to absurd results. In particular, in the court’s view, Somersworth’s interpretation would encourage manufacturers to terminate the dealer relationship as soon as manufacturers learned of a breach, rather than working with the dealer to remedy the issues. The court also held that Somersworth’s interpretation would reward dealers who are repeat offenders, while punishing manufacturers for their tolerance. None of these outcomes, in the court’s view, would advance the purpose of the statute.
TORTIOUS INTERFERENCE

This case is discussed under the topic heading “Definition of a Franchise.”

TRADE SECRETS

The Sixth Circuit affirmed the entry of a preliminary injunction preventing a franchisee from opening a second unbranded ice cream shop within blocks of its existing franchise location, utilizing the franchisor’s proprietary system and trade secrets.

In 2016, Kenneth Schulenberg executed a franchise agreement with ice cream parlor franchisor Handel’s Enterprises, Inc. (Handel’s). Thereafter, Schulenberg operated an ice cream parlor in Encinitas, California. As a Handel’s franchisee, Schulenberg participated in training at Handel’s headquarters in Ohio and was provided with a copy of the Handel’s operations manual. The operations manual included procedures for operating the store, as well as recipes for ice cream flavors. The franchise agreement required franchisees to keep the contents of the operations manual confidential, and all franchisee employees were required to sign non-disclosure agreements before viewing the operations manual. The franchise agreement also included a covenant not to compete with a two-year term following the termination of the franchise agreement and with a territory defined as a three-mile radius around the Encinitas store, as well as a portion of downtown San Diego known as the Gaslamp district. In addition, the franchise agreement stated that the confidential information provided to franchisees constituted trade secrets.

In mid-2017, Schulenberg began discussions with Handel’s regarding the possibility of opening a second franchise location in the Gaslamp district. Schulenberg and Handel’s disagreed on whether Schulenberg should be required to sign a new franchise agreement and pay a separate franchise fee. Despite the fact that Schulenberg did not sign a new agreement, he went ahead and executed a store lease in the Gaslamp district. Handel’s sent Schulenberg a notice of breach of his current franchise agreement. Schulenberg responded by filing suit in California state court seeking rescission of his franchise agreement on the alleged grounds that Handel’s failed to obtain approval of the Franchise Disclosure Document from the California Department of Business Oversight. Handel’s responded by filing suit against Schulenberg and related parties (the Defendants) in the U.S. District Court for the Northern District of Ohio asserting claims for misappropriation of trade secrets and breach of contract. Handel’s also sought a preliminary injunction to prevent Schulenberg from operating an ice cream parlor in the Gaslamp district. In the meantime,
Schulenberg opened an ice cream parlor in the Gaslamp district called Cali Cream Homemade Ice Cream (Cali Cream).

The district court granted Handel’s a preliminary injunction prohibiting the Defendants from operating an ice cream parlor that was competitive or similar to Handel’s in any way, including specifically the operation of the Cali Cream location. The Defendants appealed to the Sixth Circuit Court of Appeals.

The court considered whether Handel’s had established the factors for a preliminary injunction: (1) whether the movant has shown a strong likelihood of success on the merits; (2) whether the movant will suffer irreparable harm if the injunction is not issued; (3) whether the issuance of the injunction would cause substantial harm to others; and (4) whether the public interest would be served by issuing the injunction.

In determining whether Handel’s had shown a strong likelihood of success on its claim of misappropriation of trade secrets, the court considered the elements of such a claim: (1) the existence of a trade secret; (2) the acquisition of a trade secret as a result of a confidential relationship; and (3) the unauthorized use of a trade secret. The court determined that, under applicable Ohio law, the information provided by Handel’s to its franchisees was “not known outside the business, was heavily restricted with confidentiality agreements, and was developed over the decades which Handel’s [had] been operating.” The court also found that there was no need for Handel’s to demonstrate an actual misappropriation of the trade secret because Ohio law allows for enjoining a threatened misappropriation. The court thus found that Handel’s demonstrated a likelihood of success on its misappropriation of trade secrets claim.

The court also considered Handel’s claim that the Defendants breached the non-competition agreement. The court found that the temporal (two years) and spatial (eight block radius, plus the Gaslamp district) was appropriate. The court therefore determined that Handel’s demonstrated a strong likelihood of success on its breach of non-compete claim.

The court also found that Handel’s had demonstrated the remaining elements for an injunction. As to irreparable harm, the court noted multiple newspaper articles stating that the Cali Cream location was almost an exact replica of other Handel’s locations. As to substantial risk of harm, the court found clear harm to Handel’s and any harm to the Defendants was self-inflicted. Finally, the court found that the public interest was served through the enforcement of valid restrictive covenants in lawful contracts. The court thus upheld the injunction.

TRANSFERS


In denying plaintiff Bruno Magli IP Holdings Inc.’s (Bruno Magli) Federal Rule of Civil Procedure 12(b)(6) motion to dismiss, the U.S. District Court
for the Southern District of New York held that defendant DMODA NY, Inc. (DMODA) had sufficiently alleged that the counterclaims at issue in the case had properly been assigned from DMODA’s affiliate, Luxury Retail Partners, LLC (LRP), to DMODA and, as such, DMODA had standing to assert such claims.

On or about June 1, 2015, Bruno Magli and LRP entered into a license agreement (the License Agreement), by which LRP received a non-exclusive right to sell Bruno Magli products at retail stores in the United States. On June 28, 2016, LRP and DMODA entered into an agreement (Assignment Agreement) by which LRP assigned all of its right, title, and interest in the License Agreement to DMODA. DMODA subsequently alleged that the License Agreement created a franchise relationship between Bruno Magli and DMODA, by which Bruno Magli was required to furnish a franchise disclosure document prior to execution of the License Agreement. DMODA alleged that Bruno Magli’s failure to do so violated New York’s franchise sales act as well as Florida’s deceptive and unfair trade practices act.

Bruno Magli brought suit in New York state court, asserting breach of contract and service mark infringement claims against DMODA. DMODA removed the case to federal court and asserted counterclaims. Bruno Magli moved to dismiss the counterclaims on the basis that the initial License Agreement was between Bruno Magli and LRP (who was not a party to the lawsuit). In denying the motion, the court analyzed the requirements for standing and determined that “DMODA is not trying to bring a claim on behalf of LRP. Rather, DMODA is asserting claims that it alleges it was assigned by LRP.” The court also analyzed New York and Florida law to determine that the Assignment Agreement’s assignment from LRP to DMODA of LRP’s claims against Bruno Magli was permissible, at least at the motion to dismiss stage of the litigation. The court therefore concluded that “Bruno Magli’s motion to dismiss must be denied to the extent it argues that DMODA has not sufficiently alleged that it was assigned claims arising from the License Agreement.”

UNFAIR COMPETITION/UNFAIR AND DECEPTIVE PRACTICES


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

VICARIOUS LIABILITY


In the ongoing legal saga of the degree to which franchisors may be held vicariously liable for torts committed by their franchisees’ employees, the
U.S. District Court for the Western District of Pennsylvania held, as a matter of law, that the franchisor of the Midas automotive service center franchise system (TBC), did not exercise sufficient control over its franchisee’s day-to-day operations and employee relationships to result in vicarious liability. The court therefore granted TBC’s motion for summary judgment, holding that TBC was neither a joint employer with its franchisee nor subject to vicarious liability under an agency theory.

For less than one year, plaintiff Hannah Harris (Harris) worked as a technician at the Lower Burrell, Pennsylvania, Midas location. Harris alleged that, during her employment, the Lower Burrell Midas store manager, Ken Shick (Shick), “repeatedly sexually, physically, and emotionally harassed, assaulted, and tortured” Harris. Harris brought various claims arising out of such conduct, including claims seeking to hold TBC vicariously liable for Shick’s conduct. Although TBC had moved to dismiss the claims against it, the court denied that motion and allowed discovery to proceed. After discovery, TBC moved for summary judgment, which the court granted.

First, the court determined that TBC was not a joint employer with its franchisee. To be a joint employer, TBC was required to “exercise significant control over the same employees.” After enumerating various factors relevant to that analysis, the court held that TBC (1) did not subject the Lower Burrell store to any relevant workplace policies; (2) did not exercise any day-to-day authority at the Lower Burrell store; (3) did not discipline employees at the Lower Burrell store; (4) did not hire and fire, or set employment conditions, at the Lower Burrell store; and (5) did not control employee records, such as taxes, payroll, or insurance. Of particular relevance to this analysis was the fact that TBC was not contacted by Harris or TBC’s franchisee at the time these allegations came to light. “If [TBC] exercised authority in the areas of employee discipline and day-to-day supervision of employees, they would have been contacted by [the franchisee] or by [Harris] to address this alleged behavior.”

Second, the court concluded that TBC could not be held vicariously liable under an agency theory. In addition to reiterating TBC’s lack of control, as described in analyzing the joint employer theory, the court gave significant weight to the size and sophistication of the franchisee involved. It held that this particular franchisee “was the largest franchisee of Midas locations in the world,” and not “an unsophisticated franchisee [that] owns a single shop and requires significant support from the franchisor.” Thus, “[t]he infrastructure supporting this vast network of . . . franchises has the effect of separating [Harris], an employee at the Lower Burrell store, from [TBC] in an unmistakable manner.” In addition, the court relied on the fact that the franchise agreement specifically disclaimed an agency relationship between the parties, and the fact that any control retained by TBC related to items such as branding and royalties, no control over the employment relationship between the franchisee and its workers. As such, the court ruled, as a matter of law, that TBC was not vicariously liable for Shick’s conduct under an agency theory.