STATEMENT OF OWNERSHIP

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From the Editor-In-Chief

Gary R. Batenhorst

Thank you for reading the Spring issue of the Franchise Law Journal. Well, at least it says Spring on the cover. As I write this column, there are blizzard warnings in large parts of my state. A good day to stay inside and tell you about the great articles we have for you in this issue.

Before getting to the articles, please read the message from Julie Lusthaus and Michael Gray about the annual Forum on Franchising to be held in October in Nashville. As co-chairs of this program, Julie and Mike have assembled a great variety of topics and speakers. I am looking forward to my first visit ever to Music City and I hope you will be there as well.

We begin our articles in this issue with First Steps in Data Privacy Cases: Article III Standing by long-time Forum on Franchising stalwart Lee Plave and his colleague John Edson. Many franchise lawyers regard data breach issues as some of the most difficult issues we face. Lee and John provide a very interesting look at the standing issues that must be addressed in data breach cases, an area sometimes overlooked when we consider these cases.

We follow that article with Protecting Your Franchise Agreement: Understanding Exceptions to the Parol Evidence Rule by Christina Fugate, George Gasper, and Paul Schmitt. Franchise trial lawyers are well aware of the significant impact the parol evidence rule has on the evidence considered in franchise cases, and the authors provide us with a very good article analyzing the exceptions to this rule.

Next we explore another important litigation topic in Liquidated Damages Provisions: Strategic Drafting and Enforcement Issues by Benjamin B. Reed. Ben, who currently heads the Litigation and Dispute Resolution (LADR) division of the Forum on Franchising, gives us a comprehensive and well-written survey of important issues related to liquidated damages provisions in franchise agreements.

Gary R. Batenhorst (gbatenhorst@clinewilliams.com) is a partner in the Omaha office of Cline Williams Wright Johnson & Oldfather, L.L.P, where he focuses on franchising and distribution, business organization, and mergers and acquisitions. He welcomes comments from readers.
We follow our look at liquidated damages with a discussion of real estate issues in *Protecting Real Estate Rights When the Franchise Relationship Ends* by Meredith Barnes, Annie Caiola, Elizabeth Rose, and Andra Terrell. Real estate matters present franchisors and franchisees with a number of important concerns as a franchise relationship is ending. Meredith, Annie, Elizabeth, and Andra have drawn upon their extensive experience in this area to provide us a very helpful discussion of how to deal with these issues.

Next we turn to James Mulcahy and Douglas Luther for *Walking the Line: When Are the Franchisor's In-House Counsel's Communications or Advice to a Franchisee an Ethical Violation?* As someone who served as in-house counsel for over seventeen years, I frequently faced the issues involved in communicating with franchisees. I would have welcomed a comprehensive discussion of these issues like the one Jim and Doug give us with this article. I commend this article to all of our readers, but particularly our in-house colleagues.

Our final article in this issue is *It’s My Franchise Agreement, I’ll Enforce It However I Want To—Maybe You Will, Maybe You Won’t* by Stephanie Russ and Laura Kupish. Issues related to the selective enforcement of franchise agreements create significant problems for both franchisors and franchisees. Stephanie and Laura provide a very insightful look at these issues that will be beneficial to counsel for both franchisors and franchisees.

We conclude with the always popular *Franchising (& Distribution) Currents*. Thank you to our lead editor Dan Oates and editors Maral Kilejian and Emily Bridges for all of their hard work in preparing these Currents.

We hope you will enjoy the wide variety of excellent articles in this issue, and that reading them will inspire you to join the distinguished group of franchise lawyers who have written for the *Franchise Law Journal*. Writing for the *Journal* gives you an opportunity to contribute to the excellent scholarship that is a hallmark of the Forum and serves as a pathway toward greater involvement and leadership in the Forum. Please email me for a list of our open topics, or better yet come up with a topic of your own that interests you and start writing today.
Deadline for 2018 Edward Wood Dunham Rising Scholar Award Announced

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

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

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

We look forward to receiving the submissions!
Save the Date!

Mark your calendars for the
41st Annual Forum on Franchising
Nashville, TN
October 10-12, 2018
Franchising: Music to Your Ears

*Michael Gray and Julie Lusthaus*

The ABA Forum on Franchising Annual Meeting is headed to Music City, Nashville, home of Goo Goo Clusters and the Athens of the South.

This year’s meeting will take place October 10–12, 2018, and will provide many opportunities for socializing and networking, CLE credits, ethics credits, and the highest quality franchise programs. Whether you are experienced or new to franchise law, a litigator or transactional lawyer, in-house or outside counsel, represent franchisors or franchisees, there will be thought-provoking programs for you. The Forum will kick off with three intensive programs on Wednesday, October 10. The first is the classic *Fundamentals of Franchising* course. The second intensive will cover *The Most Common Post-Relationship Disputes* for our litigators as well as transactional lawyers who want to learn best practices for drafting post-termination contracts provisions. The third intensive program will address *The Law Department of the Future: Innovation and a New Business Model for In-House Counsel*. Open to corporate counsel as well as those in private practice, this intensive program will explore the changes in the legal industry affecting both in-house and outside counsel and how those changes will shape the law department of the future.

Our line-up of twenty-four high quality workshops will offer the best in franchise education and cover a variety of litigation, transactional, international, and regulatory issues. Topics include litigating misrepresentation claims, the new FASB rules on revenue recognition, prosecuting and defending preliminary injunctions in franchise cases, drafting the FDD for complex offerings, drafting the “other” agreements between the franchisor and franchisee, preparing clients for litigation, the scope and effectiveness of confidentiality clauses, establishing and maintaining an international compliance program, drafting and enforcing indemnification provisions, litigating the definitional elements of a franchise, and a panel of experienced judges providing a rare opportunity to hear viewpoints from the bench.

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Of course, it would not be a Forum without the signature Plenary program, *Annual Franchise and Distribution Law Developments*, an informative overview of the most important franchise and distribution cases of the past year. This program will be presented by two of our colleagues, Elliot Ginsburg and Elizabeth Weldon.

The second Plenary program, *Preparing for and Responding to an Active Shooter*, will provide an opportunity to hear from a retired FBI agent, who will not only prepare and empower attendees for such an unfortunate situation, but will also provide them with an understanding of how to plan ahead and aid in the development of an emergency action plan for their law firms, law departments, and franchise organizations.

For entertainment and nightlife, the Music City could not be more inviting. Our Thursday night event will take place at the Country Music Hall of Fame, one of the largest and most active popular music research centers and the world’s largest repository of country music artifacts. Friday’s casual event will take place at the famous Wildhorse Saloon in the center of Nashville’s famous honky-tonk district so grab your cowboy boots and cowboy hat and gather with friends and colleagues for an evening of great food, dancing and good cheer.

Join us in Nashville, Tennessee for the 41st Annual Forum on Franchising, October 10–12 where *Franchising Is Music to Your Ears*.
First Steps in Data Privacy Cases: Article III Standing

Lee J. Plave and John W. Edson

A recent string of prominent cybersecurity attacks, which have affected parties ranging from Fortune 500 companies to the Democratic National Committee, illuminate the perils of operating a business in an era of ubiquitous connectivity.¹ In September 2017, Equifax Inc., a consumer credit reporting agency, announced that the personal data of nearly 143 million of its users had been compromised by hackers who were able to roam its network undetected for upwards of four months.² The fallout from the Equifax data breach has already led to numerous class action lawsuits,³ the ouster of Equifax’s longtime CEO,⁴ and a series of very public reprimands on Capitol Hill.⁵ In February 2018, the company reportedly confirmed that the extent of the records and details accessed in the hack may be substantially greater—and more troublesome—than initially believed.⁶


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In October 2017, Yahoo! announced that a 2013 cyberattack, which the company had originally estimated as affecting one billion of its users’ accounts, had in fact affected all three billion of its users.7 In the wake of this breach, Yahoo! stands likely to defend one or more of the largest class action lawsuits in history.8

Although the sheer magnitude of the Equifax and Yahoo! data breaches have led these events to dominate headlines, they are only two instances among a proverbial tidal wave of cybersecurity incidents.9 The Identity Theft Resource Center, a non-profit group that tracks data breaches, estimates that the total number of U.S. data breaches reached an all-time high of 1,579 in 2017, a 45% increase from 2016, and a 102% jump from 2015.10 The franchise industry is certainly not immune. Wendy’s, Jimmy John’s, Wyndham Hotels and Resorts, and Sonic Drive-In are among a long list of franchise systems targeted by cyberattacks in recent years.11

Although companies that fall victim to a data breach are likely to face a variety of economic and legal consequences,12 finding an effective way to defend against consumer-driven class action lawsuits stemming from a breach presents one of the most difficult, and potentially costly, challenges.13

(Addressing the breadth and implications of the Equifax breach, the author observed that “[t]he fact that hackers accessed even more data [from Equifax than first reported] shows both the vast amount of information that Equifax holds and the risks at stake for consumers given the level of personal information that has been compromised.”) (emphasis added).

10. Id.
12. See generally Michael K. Lindsey & Mark S. Melodia, Data Protection and Privacy in Franchising: Who is Responsible? ABA 36th FORUM ON FRANCHISING, W-16 (2013) (providing an overview of the various economic and legal consequences facing franchise companies that fall victim to a breach).
13. See Travis LeBlanc & Jon R. Knight, A Wake-Up Call: Data Breach Standing is Getting Easier, CYBER SECURITY LAW REP. (Jan. 17, 2018), at 4, available at https://www.bsflp.com/images/content/2/9/v2/2995/2018-01-17-Cyber-Security-Wake-Up-Call-Data-Breach-Standing-Is.pdf (“In less than two months after its market-moving breach was announced, Equifax incurred $87.5 million in expenses relating to the breach litigation and government investigations.”). Obviously, there is also the risk of an enforcement action by a government agency, such as the Federal Trade Commission, which brought such an action against the franchisor of the “Wyndham Hotel” system in 2012. Fed. Trade Comm’n v. Wyndham Worldwide Corp., No. 2:13-CV-
cial uncertainty on how to approach these cases has added an extra layer of complexity for companies hoping to develop an effective post-breach litigation strategy.

As private lawsuits stemming from data breaches wend their way through the judicial system, federal courts have struggled to reach a clear consensus on when the owners of compromised data may seek recovery. Specifically, following the Supreme Court’s 2016 decision in Spokeo, Inc. v. Robins (Spokeo I), federal courts are split on whether the threat of future harm attributable to a data breach gives a plaintiff standing to sue the company that allegedly failed to protect his or her personally identifiable information (PII).

This article first addresses why recent judicial developments relating to standing in data privacy cases should be of particular importance to franchise companies. Then, the article provides a general overview of the standing doctrine and summarizes recent federal court holdings addressing data privacy standing.

I. Background

Why should franchise companies, in particular, care about tracking federal jurisprudence on a rather technical issue of constitutional law? First, in certain instances, franchise companies have proven to be susceptible to cyberattacks. Second, the likelihood and frequency at which data breach lawsuits make it past the pleading stage would significantly impact a company’s data protection policies and litigation strategies. In practical terms, most data breach cases involving franchise systems are either decided in the early stages—for example, a Motion to Dismiss on the issue of standing—or settled. Thus, standing issues have a significant impact on whether a class action brought against a franchisor and its franchisees is dismissed at an early stage or whether the case proceeds ahead (e.g., if standing is found); and if so, the matter is typically resolved by settlement before a trial on the merits.

Unfortunately, some franchise systems have become an attractive target for cybercriminals due to the nature and volume of the information they collect, as well as their inherently diffuse structure. Franchise systems, particularly those in the hospitality and restaurant industries, often have numerous locations, each of which may process hundreds of small credit card transactions a day through an interconnected point-of-sale (POS) system. This

01887-ES-JAD (D.N.J. June 26, 2012). The risk and management of government enforcement actions falls outside the scope of this article.

steady stream of connected transactions may prove to be a compelling target for resourceful hackers.\textsuperscript{17} Complicating matters is that a franchise system is made up of a multitude of independently owned and operated entities utilizing a common brand. Each franchisor and each franchise owner may have a different understanding of its cybersecurity exposure and may have different data protection safeguards and systems. Thus, auditing and implementing system-wide policies may be challenging.

The well-publicized data breach involving the Wendy’s restaurant chain highlights the vulnerabilities and consequences that many franchise systems face.\textsuperscript{18} In the Wendy’s breach, hackers installed malicious software, or malware, on the POS systems that were in use at numerous franchised Wendy’s locations.\textsuperscript{19} The malware allegedly allowed hackers to collect payment card data (e.g., credit and debit card information, expiration dates, card verification numerals, and PIN data for debit cards) from each customer transaction at the nearly 1,025 Wendy’s locations using that POS system.\textsuperscript{20}

Once the breach was discovered, Wendy’s conducted an internal investigation and determined that a third-party vendor was to blame.\textsuperscript{21} Wendy’s alleged that hackers somehow acquired the credentials of one of the vendor’s employees and used those credentials to access the POS system and install the malware.\textsuperscript{22}

Customers affected by the breach argued that Wendy’s maintained “an insufficient and inadequate system to protect its customers’ private information.”\textsuperscript{23} These allegations eventually culminated in the filing of two groups of class action lawsuits, one originating from the consumers claiming to have been affected and the other from the financial institutions responsible for reimbursing the resulting fraudulent charges.\textsuperscript{24} In the consumer case, the plaintiffs argued, among other things, that the compromise of their personal information put them at a greater risk of future fraud or harm.\textsuperscript{25}

The likelihood that consumer lawsuits like the one stemming from the Wendy’s breach will make it past the pleading stage has major implications for companies. Perhaps most significantly, the cost of actually litigating, or even settling, a major data breach lawsuit can be astronomical.\textsuperscript{26}

\textsuperscript{17.} Id.
\textsuperscript{18.} See Torres v. Wendy’s Co., 195 F. Supp. 3d 1278 (M.D. Fla. 2016); Krebs, supra note 11.
\textsuperscript{19.} Torres, 195 F. Supp. 3d at 1280.
\textsuperscript{20.} See id.; Krebs, supra note 11.
\textsuperscript{21.} Torres, 195 F. Supp. 3d at 1280.
\textsuperscript{23.} Torres, 195 F. Supp. 3d at 1281.
\textsuperscript{25.} Torres, 195 F. Supp. 3d at 1283.
\textsuperscript{26.} See Lindsey, supra note 12, at 16–17 (discussing data privacy class actions that have resulted in settlement); LeBlanc, supra note 13.
Private lawsuits are not the only consequence facing companies that fall victim to a data breach. A breached company will also likely be faced with mitigating damage to its brand reputation, navigating a multitude of breach notification laws, and defending against state and federal law enforcement actions. Thus, with all these competing concerns, the need for some semblance of predictability when crafting a post-breach litigation strategy is abundantly clear.

II. Overview of Standing in Data Privacy Cases Pre-Spokeo I

In many data breach lawsuits, plaintiffs who have had their personal data compromised are unable to prove that they are actually the victim of fraud or have suffered any tangible economic loss. Instead, these plaintiffs generally argue that, because of the data breach, they are at a greater risk of future identity theft or other harm.

Historically, federal lawsuits based on the threat of future harm have been easily dismissed at the pleading stage for lack of standing. However, recent federal jurisprudence has signaled a willingness by some circuits to lower the bar necessary for plaintiffs to establish the standing required to bring a case on these grounds.

This section will first provide an overview of the general requirements for establishing Article III standing in federal courts. Next, this section will summarize recent federal court opinions addressing standing in data privacy cases.

A. General Requirements for Article III Standing

Article III of the United States Constitution limits the jurisdiction of federal courts to hearing “cases” and “controversies.” This limitation is designed to ensure that federal courts remain in their “judicial role” and do not “intrude upon the powers given to the other branches.” The doctrine of standing is “rooted in the traditional understanding” of “case” and “controversy” and exists to ensure that the proper litigant is the party bringing a particular lawsuit.

In *Lujan v. Defenders of Wildlife*, the U.S. Supreme Court laid out the “irreducible constitutional minimum” requirements for establishing Article III

30. U.S. CONST. art. III, § 2, cl. 1; see also Spokeo, Inc. v. Robins, 136 S. Ct. 1540 (2016), as revised (May 24, 2016) (Spokeo I).
31. Spokeo I, 136 S. Ct. at 1547.
32. Id.
standing. Under the Lujan test, a plaintiff must show it has: (1) suffered an “injury-in-fact;” (2) that is fairly traceable to the challenged conduct of the defendant; and (3) that is likely to be redressed by a favorable judicial decision. The Lujan test requires that the injury-in-fact alleged by the plaintiff must be both “concrete and particularized” and “actual or imminent, not conjectural or hypothetical.”

In data breach cases, the injury-in-fact element has proved to be a difficult hurdle for many plaintiffs to clear because courts are split on whether the inchoate risk of future identity theft or other harm often attributed to a breach is sufficiently concrete to qualify as an injury-in-fact.

B. Early Circuit Split on Standing in Data Privacy Cases

Federal courts have reached different conclusions about standing in data privacy cases in recent years. The split in the circuits dates back more than a decade. In a 2007 decision, Pisciotta v. Old National Bancorp, the Seventh Circuit advanced a brief, but expansive, interpretation of the injury-in-fact requirement. Pisciotta involved a “sophisticated, intentional, and malicious” security breach of a bank’s website. Hackers were able to access sensitive information belonging to Old National Bancorp’s (ONB) customers and potential customers, which included names, addresses, Social Security numbers, credit card numbers, and other financial account numbers. After learning of the breach, ONB customers filed negligence and breach of contract claims against the bank and its web-hosting provider, NCR.

Interestingly, the plaintiffs did not allege “any completed direct financial loss,” nor did they claim that they “already had been the victim of identity theft as a result of the breach.” Instead, the plaintiffs argued they were harmed by having to purchase “past and future credit monitoring services” that they had obtained “in response to the compromise of their personal data through ONB’s website.”

The Seventh Circuit acknowledged the prevailing view in other circuits that plaintiffs whose data had been compromised, but not yet misused, had not suffered an injury-in-fact sufficient to confer Article III standing. Nonetheless, the court held that the injury-in-fact requirement needed to create standing may be established by “a threat of future harm or by an act which harms the plaintiff only by increasing the risk of future harm

34. Id.
35. Id. at 560.
36. 499 F.3d 629 (7th Cir. 2007).
37. Id. at 632.
38. Id. at 631.
39. Id. at 632.
40. Id. (emphasis in original).
41. Id. at 631.
42. Id. at 634.
that the plaintiff would have otherwise faced, absent the defendant’s actions.\textsuperscript{43}

In \textit{Krottner v. Starbucks Corp.}, the Ninth Circuit also showed a willingness to allow plaintiffs to use the threat of future harm to establish standing.\textsuperscript{44} \textit{Krottner} involved a stolen Starbucks Corporation laptop containing the unencrypted names, addresses, and Social Security numbers of approximately 97,000 Starbucks employees.\textsuperscript{45} When Starbucks learned of the theft, it sent a letter to its employees stating that although there was no indication the private information was misused, the company would nonetheless offer employees free credit reporting services for a limited period of time.\textsuperscript{46}

Following receipt of the letter, three Starbucks employees filed suit, alleging negligence and breach of contract.\textsuperscript{47} One of the plaintiffs, Krottner, alleged she was spending a “substantial amount of time” reviewing her financial accounts and felt compelled to continue paying for credit monitoring services once the free service expired.\textsuperscript{48} Another plaintiff, Lalli, alleged he had developed “generalized anxiety and stress regarding the situation.”\textsuperscript{49} A third plaintiff, Shamasa, alleged his bank notified him that someone had attempted to open a new account using his Social Security number, although the bank had closed the account before he suffered any financial loss.\textsuperscript{50} The district court dismissed the case, finding that the plaintiffs had failed to allege a cognizable injury.\textsuperscript{51}

On appeal, the Ninth Circuit reversed, finding that all three plaintiffs had sufficiently alleged an injury-in-fact for purposes of Article III standing.\textsuperscript{52} The court held that Lalli easily established standing because he had established a “present injury.”\textsuperscript{53} However, the appeals court took a more nuanced approach to the allegations of increased risk of future identity theft advanced by Krottner and Shamasa.\textsuperscript{54} Acknowledging that it had not yet determined whether the increased risk of identity theft constituted an injury-in-fact, the Ninth Circuit analogized the plaintiffs’ allegations to claims of future harm advanced in toxic tort and environmental cases.\textsuperscript{55} The court noted that in those contexts it had held that a plaintiff could establish standing as long as the plaintiff faced “a credible threat of harm.”\textsuperscript{56} Reviewing the

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\textsuperscript{43} Id.
\textsuperscript{44} 628 F.3d 1139 (9th Cir. 2010).
\textsuperscript{45} Id. at 1140.
\textsuperscript{46} Id. at 1140–41.
\textsuperscript{47} Id. at 1141.
\textsuperscript{48} Id.
\textsuperscript{49} Id.
\textsuperscript{50} Id.
\textsuperscript{52} Krottner, 628 F.3d at 1142.
\textsuperscript{53} Id.
\textsuperscript{54} Id.
\textsuperscript{55} Id.
\textsuperscript{56} Id.
facts in this case, the Ninth Circuit found that the theft of the laptop containing the plaintiffs’ PII created a “credible threat of harm” for the plaintiffs that was “both real and immediate, not conjectural or hypothetical.”

In Riley v. Ceridian Corp., the Third Circuit rejected the line of reasoning advanced by the Seventh and Ninth Circuits, holding that allegations of “hypothetical, future injury” are not sufficient to establish standing. The dispute in Riley arose from the breach of Ceridian Corporation, a payroll processing firm, which allowed a hacker to gain unauthorized access to information about approximately 27,000 employees at 1,900 companies. However, although it was clear that the hacker had accessed Ceridian’s database, it was not apparent whether the hacker “read, copied, or understood” the data.

Following the breach, the employees of one of Ceridian’s customers filed suit, alleging Ceridian’s failure to protect against the breach caused the plaintiffs to (1) suffer an increased risk of identity theft, (2) incur costs to monitor their credit activity, and (3) suffer from emotional distress. In finding that the plaintiffs lacked standing to bring the case, the Third Circuit focused on the speculative nature of the plaintiffs’ claims. The court noted that whether the plaintiffs actually suffered any harm relied on the “speculative, future actions of an unnamed-known party,” or more specifically, that the hacker had actually “(1) read, copied, and understood their personal information; (2) intended to commit future criminal acts by misusing the information; and (3) was able to use such information to the detriment of [plaintiffs] by making unauthorized transactions in [plaintiffs’] names.” Since both the skill and the intent of the hacker were unknown, the court held that the threatened harm was neither the “imminent” nor “certainly impending” enough to create the type of injury necessary to establish standing.

C. Supreme Court’s First Opportunity to Provide Clarity

The U.S. Supreme Court had its first opportunity to clarify Article III standing in data privacy cases in 2013 in Clapper v. Amnesty International USA. In Clapper, a group of plaintiffs—which included attorneys, journalists, and human rights organizations—challenged the constitutionality of a provision of the Foreign Intelligence Surveillance Act (FISA). The provision in question allowed the U.S. government to conduct surveillance on non-U.S. citizens outside the United States. The plaintiffs, who for a vari-

57. Id.
58. 664 F.3d 38, 41 (3d Cir. 2011).
59. Id. at 40.
60. Id.
61. Id.
62. Id. at 41.
63. Id. at 42.
64. Id. at 44.
66. Id. at 406.
67. Id. at 401.
ety of reasons believed they might come into contact with targeted individuals through their work, alleged that their communications would also be captured by government agents. The plaintiffs sought a declaration that the FISA provision was unconstitutional as a violation of their Fourth Amendment rights. The district court dismissed the case for lack of standing, and the Second Circuit reversed on appeal. The Supreme Court ultimately reversed and remanded to the Second Circuit, holding that the plaintiffs lacked standing to assert those claims.

The plaintiffs’ argument that they had suffered an injury-in-fact, and therefore had standing to bring the case, was based on two alternative theories. First, the plaintiffs argued there was an “objectively reasonable likelihood” that their communications would be captured. In the alternative, the plaintiffs argued they suffered harm as a result of the additional steps they needed to take to preserve their confidentiality in light of the new provision.

The Supreme Court rejected both arguments. First, the Court rejected the “objectively reasonable likelihood standard” as “inconsistent with [its] requirement that threatened injury must be certainly impending to constitute injury in fact.” The Court reasoned that the plaintiffs’ theory of harm was based on a “speculative chain of possibilities” and was therefore not “certainly impending.” Highlighting policy concerns, the Court also rejected the plaintiffs’ alternative argument. The Court concluded that, by allowing plaintiffs to “manufacture standing” based on “their fears of future harm . . . [that] an enterprising plaintiff would be able to secure a lower standard for [standing] simply by making an expenditure based on a non-paranoid fear.”

The Court did, however, decide to qualify its “certainly impending” standard and, in doing so, injected an element of ambiguity. In a footnote, the Court explained that in order to establish the future harm was “certainly impending,” plaintiffs did not have to prove they were “literally certain” the stated harm would occur. Rather, the Court stated that, in some circumstances, a plaintiff could establish standing by showing there was “substantial risk” that the foreseen harm would occur. Thus, the Clapper decision left the door open for varying interpretations of the standard for

68. Id. at 407.
69. Id. at 401.
70. Id. at 407.
71. Id. at 408.
72. Id. at 401–02.
73. Id. at 401.
74. Id. at 402.
75. Id. at 410.
76. Id. at 414.
77. Id. at 416.
78. Id.
79. Id. at 414 n.4.
80. Id.
81. Id.
injury-in-fact, and the circuits have continued to reach differing conclusions since Clapper.82

In 2016, the Supreme Court again had an opportunity to set a clear standard for establishing Article III standing in a data privacy case in Spokeo I.83 Spokeo I stemmed from alleged violations of the Fair Credit Report Act (FCRA), which was enacted to ensure that credit reporting agencies followed “reasonable procedures to assure maximum possible accuracy of” certain consumer reports.84

The defendant, Spokeo, Inc., operated a “people search engine,” which aggregates personal information about individuals from the web for a variety uses, such as the evaluation of prospective employees by employers.85 The plaintiff discovered that his “Spokeo” profile contained inaccurate information and filed suit, alleging that Spokeo, Inc. failed to comply with the terms of FCRA.86 The district court dismissed the case for lack of standing and the Ninth Circuit reversed.87 The Supreme Court reversed and remanded the case, holding that the Ninth Circuit had failed to consider all aspects of the injury-in-fact requirement, namely, whether a “concrete harm” existed.88

Although the Supreme Court stopped short of saying whether plaintiffs had standing, it provided some guidance by clarifying that a mere statutory violation, without a showing of concrete harm, is not enough to establish Article III standing.89 However, the Court qualified that a “concrete harm” does not necessarily mean a “tangible harm” in the traditional sense, and that in some cases Congress was equipped to identify “intangible harms” that could establish injury-in-fact.90 Specifically, the Court explained that “[t]he violation of a procedural right granted by statute can be sufficient in some circumstances to constitute injury in fact; in such a case, a plaintiff need not allege any additional harm beyond the one identified by Congress.”91

Thus, the Supreme Court in Spokeo I did not completely open or close the door. Rather, it remanded the case, indicating that a fact-specific inquiry was needed to determine whether an alleged violation of a statutory procedural

84. Id. at 1545.
85. Id. at 1544.
86. Id.
87. Id.
88. Id. at 1545.
89. Id. at 1545.
90. Id. at 1549.
right is—of its own accord—enough to show the “concrete harm” needed to confer standing.92

On remand (Spokeo II), the Ninth Circuit interpreted Spokeo I as confirming that mere procedural statutory violations, absent any other harm, are in some instances sufficient to confer Article III standing.93 In determining whether a violation of the FCRA could result in the type of concrete injury necessary to establish standing, the court considered: (1) whether the statutory provision at issue was enacted to protect a concrete interest (as opposed to a procedural one); and (2) whether the procedural violation either harmed, or presented a risk of material harm, to that interest.94 Concluding that a concrete injury existed, the Ninth Circuit reasoned that Congress had enacted the FCRA to “protect consumer privacy,” and that the harms resulting from a FCRA violation, namely, material inaccuracies in a consumer report, seemed “patent on their face.”95

III. Summary of Data Privacy Standing Cases Following Spokeo I

Following the Supreme Court’s decision in Spokeo I, courts in most of the circuits have weighed in on the topic of data privacy standing. More courts seem willing to advance a relaxed interpretation of the injury-in-fact element necessary to establish standing, causing different courts to reach different results on similar facts.

This section summarizes recent holdings involving standing in data privacy cases. The cases are best reviewed in two distinct sub-categories: (1) cases involving alleged statutory violations; and (2) cases resulting from data breaches.

A. Cases Involving Alleged Statutory Violations

One line of reasoning adopted in the Third and Eleventh Circuits, as well as other district courts, concludes that, in certain instances, procedural violations of a statute are sufficient to create the injury-in-fact necessary for a plaintiff to establish standing. In contrast, courts in the Second, Seventh, Eighth, and D.C. Circuits have held that, even where Congress has accorded procedural rights to citizens to protect a concrete interest, a plaintiff will not establish standing if the alleged statutory violation presents no material risk of harm to that interest.

1. Third and Eleventh Circuits View: Standing Found

In In re Horizon Healthcare Services, Inc. Data Breach Litigation, the Third Circuit held that a procedural violation of the FCRA was, on its own, suffi-

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92. See id.
94. Id. at 1113.
95. Id. at 1114.
cient to establish standing for the plaintiffs.\textsuperscript{96} Horizon Healthcare Services resulted from the theft of two laptops containing “differing amounts of member information” from Horizon Healthcare Services, Inc.’s headquarters.\textsuperscript{97} Shortly after learning of the break-in, Horizon notified its members that their personal information may have been compromised and offered free credit monitoring services.\textsuperscript{98}

Four Horizon members subsequently filed suit.\textsuperscript{99} In their complaint, the plaintiffs did not allege their identities were stolen as a result of the breach.\textsuperscript{100} Instead, they argued Horizon had violated the FCRA by “furnish[ing]” their information in an unauthorized fashion by allowing that information to fall into the hands of thieves and by failing to adopt reasonable procedures to keep the information confidential.\textsuperscript{101}

The district court dismissed the case, holding that the plaintiffs did not have standing because they had not suffered a “cognizable injury.”\textsuperscript{102} The Third Circuit reversed, holding that, in certain instances, a facial violation of a statute was enough to form the injury-in-fact necessary to establish standing.\textsuperscript{103} The court reasoned:

The actual or threatened injury required by Art[icle] III may exist solely by virtue of statutes creating legal rights, the invasion of which creates standing, even absent evidence of actual monetary loss. . . . [W]ith the passage of the FCRA, Congress established that the unauthorized dissemination of [plaintiffs’] private information by a credit reporting agency causes an injury in and of itself—whether or not the disclosure of that information increased the risk of identity theft or some future harm.\textsuperscript{104}

The court concluded that \textit{Spokeo I} did not modify the injury-in-fact requirement or “erect any new barrier” for plaintiffs hoping to establish standing.\textsuperscript{105}

\begin{thebibliography}{99}
\bibitem{96} 846 F.3d 625, 641 (3d Cir. 2017).
\bibitem{97} Id. at 630.
\bibitem{98} Id. Offering customers free credit monitoring services is a commonly employed practice for companies that have fallen victim of breach. However, some plaintiffs and courts have viewed offering these services as an admission that the plaintiff is at a greater risk of future harm. See Galaria v. Nationwide Mut. Ins. Co., 663 F. App’x 384, 388 (6th Cir. 2016) (“There is no need for speculation where Plaintiffs allege that their data has already been stolen and is now in the hands of ill-intentioned criminals. Indeed, Nationwide seems to recognize the severity of the risk, given its offer to provide credit-monitoring and identity-theft protection for a full year”).
\bibitem{99} \textit{In re Horizon Healthcare}, 846 F.3d at 631.
\bibitem{100} Id.
\bibitem{101} Id.
\bibitem{102} Id. at 632.
\bibitem{103} Id. at 641. Interestingly, in interpreting the Federal Trade Commission Act, the Third Circuit reached a different conclusion in an earlier case involving an alleged data breach at certain Wyndham branded hotels. In \textit{FTC v. Wyndham Worldwide Corp.}, 799 F.3d 236, 255–56 (3d Cir. 2015), the Third Circuit applied a cost-benefit analysis to the FTC’s argument that possible identity theft, on its own, was enough to establish injury under the FTC Act. The court explained that the relevant inquiry under the FTC Act was whether “the act or practice causes or is likely to cause substantial injury to consumers which is not reasonably avoidable by consumers themselves and not outweighed by countervailing benefits to consumers or to competition.”
\bibitem{104} \textit{In re Horizon Healthcare}, 846 F.3d at 639.
\bibitem{105} Id. at 638.
\end{thebibliography}
To the contrary, the Third Circuit interpreted *Spokeo I* as reemphasizing that Congress “has the power to define injuries” through legislation.106

The U.S. District Court for the Northern District of California reached a similar conclusion in *Matera v. Google, Inc.*107 In *Matera*, the plaintiffs alleged that Google violated various state and federal anti-wiretapping laws through its operation of its “Gmail” application.108 The plaintiffs alleged that Google intercepted their emails for the dual purposes of (1) providing advertisements targeted to the email’s recipient or sender; and (2) creating user profiles to advance Google’s profit interests, without the plaintiff’s knowledge or consent. Google sought to dismiss the plaintiff’s suit for lack of standing.109

Citing *Spokeo I*, the district court rejected Google’s argument and instead held that, in certain instances, the violation of a right granted by statute may be sufficient to constitute injury-in-fact.110 However, the court observed in dictum that Google was correct that “not every harm recognized by statute will be sufficiently ‘concrete’ for standing purposes.”111 The court noted that whether a violation of a statute establishes concrete injury is contingent on two-factors: (1) whether the statutory violation bears a “close relationship to a harm that has traditionally been regarded as providing a basis for a lawsuit in English or American courts;” and (2) whether Congress, in enacting the statute, intended for the statutory right to be substantive or procedural.112

In applying this test, the *Matera* court first noted that the violation of the wiretapping and privacy laws had a close relationship to the common law tort of invasion of privacy.113 Second, the court found that Congress had created substantive rights because the statutes were intended to protect individuals from invasions of their privacy.114

In 2016, the U.S. District Court for the Southern District of Florida addressed data privacy standing in a case involving a franchise company. In *Flaum v. Doctor’s Associates, Inc.*,115 the court allowed a suit alleging violations of the Fair and Accurate Credit Transaction Act (FACTA) to proceed past the pleading stage, even though the plaintiff had not claimed any present harm.116

*Flaum* involved a consumer class action lawsuit against Doctor’s Associates, Inc. (DAI), the franchisor of the Subway sandwich shop system.117

106. Id.
108. Id.
109. Id.
110. Id. at *19; see also *Van Patten v. Vertical Fitness Group, LLC*, 847 F.3d 1037 (9th Cir. 2017) (holding that a facial violation of the Telephone Consumer Protection Act (TCPA) is enough to show a concrete, *de facto* injury because “Congress identified unsolicited contact as a concrete harm, and [by enacting TCPA] gave consumers a means to redress this harm”).
112. Id.
113. Id. at *10–11.
114. Id. at *10–14.
115. 204 F. Supp. 3d 1337 (S.D. Fla. 2016).
116. See id.
117. Id.
Flaum alleged that DAI violated FACTA when it printed his full credit card expiration date after he made a purchase at a franchisee-owned Subway shop in Florida.¹¹⁸ DAI moved to dismiss, arguing that Flaum failed to allege a concrete injury-in-fact and therefore lacked the requisite standing to bring the case.¹¹⁹

The district court rejected DAI’s motion.¹²⁰ Citing *Spokeo I*, the court held that, in certain instances, a statutory violation on its own can create the requisite injury necessary to establish Article III standing, because Congress has the power to elevate to the status of legally cognizable injuries concrete de facto injuries, that were previously inadequate in law.”¹²¹ The court explained that the critical inquiry is whether Congress, in enacting FACTA, meant to create “a substantive right for consumers to have their personal credit card information truncated on printed receipts, or merely created a procedural requirement for credit card-using companies to follow.”¹²²

After analyzing both the nature of the harm the statute was designed to prevent, as well as FACTA’s legislative history, the court concluded that Congress had intended to create a substantive privacy right for consumers.¹²³ Thus, the court concluded that, due to information printed on the receipts, the plaintiffs had suffered “concrete harm,” and therefore denied DAI’s motion to dismiss for lack of standing.¹²⁴

The Eleventh Circuit adopted a similar approach in two subsequent decisions. In *Church v. Accretive Health, Inc.*, a hospital management company sent the plaintiff a letter advising her that she owed a debt to a particular hospital.¹²⁵ The plaintiff filed suit, alleging that the hospital management company had failed to include certain disclosures required by the Fair Debt Collections Practices Act (FDCPA) in the letter.¹²⁶

In *Church*, the plaintiff did not allege that she suffered actual damages from the company’s failure to include the FDCPA required disclosures in its letters.¹²⁷ Still, the Eleventh Circuit held the plaintiff adequately alleged a concrete injury sufficient to confer standing because: (1) in enacting the FDCPA, Congress created a substantive right to receive the required disclosures in relevant communications; and (2) the defendant violated this substantive right by failing to include the required disclosures in its letter.¹²⁸

Another similar case was heard in the U.S. District Court for the Southern District of Florida. In *Wood v. J Choo USA, Inc.*, the plaintiff, a customer

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¹¹⁸. *Id.* at 1338.
¹¹⁹. *Id.* at 1339.
¹²⁰. *Id.* at 1337.
¹²¹. *Id.* at 1340.
¹²². *Id.* at 1341.
¹²³. *Id.* at 1341–42.
¹²⁴. *Id.* at 1342.
¹²⁵. 654 F. App’x 990, 992 (11th Cir. 2016).
¹²⁶. *Id.*
¹²⁷. *Id.*
¹²⁸. *Id.* at 994–95.
of a Jimmy Choo retail store in Palm Beach Gardens, alleged that the retailer violated FACTA after it provided her with a receipt containing her full credit card expiration date. The plaintiff did not allege any tangible harm and instead argued that by violating FACTA, the retailer exposed the plaintiff and the putative class members to an elevated risk of identity theft.129

The district court denied the retailer’s motion to dismiss for lack of standing, finding that, by enacting FACTA, Congress created a substantive legal right for card-holding consumers to receive receipts truncating their personal credit card numbers and expiration dates and, thus, protecting their personal financial information. According to the court, the plaintiff suffered a concrete harm as soon as the retailer printed the offending receipt, and therefore, had shown the injury-in-fact necessary to establish Article III standing.130

2. Second, Seventh, Eighth, and D.C. Circuits: Standing Called into Question

Courts in other circuits have been more reluctant to confer standing to plaintiffs on the mere basis of a statutory violation. In Strubel v. Comenity Bank, the Second Circuit determined that an alleged violation of the Truth in Lending Act was not sufficient, on its own, to establish standing if the plaintiff could not show further harm.131 Rather, the court concluded that:

[W]e understand *Spokeo*, and the cases cited therein, to instruct that an alleged procedural violation can by itself manifest concrete injury where Congress conferred the procedural right to protect a plaintiff’s concrete interests and where the procedural violation presents a “risk of real harm” to that concrete interest. But even where Congress has accorded procedural rights to protect a concrete interest, a plaintiff may fail to demonstrate concrete injury where violation of the procedure at issue presents no material risk of harm to that underlying interest.132

The Second Circuit has also addressed standing in a case involving alleged FACTA violations.133 Much like *Flaum* and *Wood*, the plaintiffs in *Cruper-Weinmann v. Paris Baguette America, Inc.* alleged that a retailer violated FACTA when the retailer gave them receipts containing their full credit card expiration date. However, unlike the courts in the Eleventh Circuit, the Second Circuit applied a much narrower interpretation of *Spokeo I*.134

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130. *Id.*
131. *Id.* at 1340.
132. *Id.*
133. 842 F.3d 181, 185 (2d Cir. 2016).
134. *Id.* at 190.
137. *Cruper-Weinmann*, 861 F.3d at 77.
Applying Strubel, the Second Circuit noted that the key inquiry was whether the retailer’s printing of the plaintiff’s credit card expiration date on her receipt presented “a material risk of harm to the underlying concrete interest Congress sought to protect in passing FACTA.”138 Concluding that the plaintiff failed to show any material risk of real harm, the court pointed to the fact that Congress itself “did not think that the inclusion of a credit card expiration date on a receipt increases the risk of material harm of identity theft.” 139

The Seventh Circuit’s 2016 decision in Meyers v. Nicolet Restaurant of De Pere, LLC applied an approach that effectively is the same as the Second Circuit’s approach in Cruper-Weinmann.140 Similar to other cases alleging FACTA violations, the plaintiff in Meyers sued a restaurant that gave him a receipt that failed to truncate his credit card expiration date.141 The Seventh Circuit in Meyers held that the plaintiff had failed to allege concrete injury and, therefore, lacked standing.142 The court explained that the plaintiff had not suffered a concrete injury because he discovered the violation immediately, nobody else ever saw the receipt, and the mere printing of a card’s expiration date, without more, would not heighten the risk of identity theft.143

In Braitberg v. Charter Communications, Inc., the Eighth Circuit addressed whether the alleged improper retention of PII, on its own, was sufficient to confer standing.144 In Braitberg, the plaintiff brought a putative class action lawsuit against his former cable television provider, Charter Communications. The plaintiff alleged that Charter violated the Communications Protection Act by retaining personally identifiable information of its customers after they had canceled their subscriptions and after that information was no longer needed to provide services or collect payments.145 The district court dismissed the case for lack of standing.146

The Eighth Circuit upheld the district court, finding that the plaintiff had not shown the concrete harm necessary to establish standing.147 The Eighth Circuit rejected the plaintiff’s argument that, by virtue of a violation of a statutory right, the plaintiff did not need to allege or show any “actual in-
jury” arising from Charter’s retention of his personal information.\textsuperscript{148} Citing Spokeo \textit{I}, the court noted that “Congress’ role in identifying and elevating intangible harms does not mean that a plaintiff automatically satisfies the injury-in-fact requirement whenever a statute grants a person a statutory right and purports to authorize that person to sue to vindicate that right,” and that Article III “requires a concrete injury even in the context of a statutory violation.”\textsuperscript{149}

The court found instead that the plaintiff’s allegations amounted to “a bare procedural violation, divorced from any concrete harm.”\textsuperscript{150} The court pointed to the fact that the plaintiff did not allege that Charter had disclosed the information to a third party, that any outside party had accessed the data, or that Charter had used the information in any way during the disputed period.\textsuperscript{151}

The D.C. Circuit has also held that statutory violations, absent other harm, did not create the type of injury-in-fact necessary to establish standing.\textsuperscript{152} In Hancock \textit{v. Urban Outfitters Inc.}, customers filed suit against Urban Outfitters, Inc. and Anthropologie, Inc., alleging that both retailers violated the District of Columbia Consumer Identification Information Act (CII Act) by requesting customer ZIP codes in connection with consumer credit card purchases.\textsuperscript{153} The CII Act states, among other things, that a party may not “request or record the address or telephone number of a credit card holder” as a condition of accepting a credit card as a form of payment for the sale of goods or services.\textsuperscript{154} The plaintiffs did not allege any harm beyond being asked for their ZIP codes.\textsuperscript{155}

The D.C. Circuit found that the plaintiffs’ complaint did “not get out of the starting gate.”\textsuperscript{156} The court pointed to the fact that the plaintiffs failed to allege any cognizable injury as a result of providing their ZIP codes.\textsuperscript{157} Citing Spokeo \textit{I}, the court explained that although a legislature may indeed “elevat[e] to the status of legally cognizable injuries concrete, de facto injuries that were previously inadequate in law,’ the legislature cannot dispense with the constitutional baseline of a concrete injury in fact.”\textsuperscript{158} Thus, even in claims alleging violation of statutory conferred rights, the asserted injury “must actually exist” and must impact the plaintiff in a “personal and individual way.”\textsuperscript{159}

\begin{itemize}
\item \textsuperscript{148} Id. at 930.
\item \textsuperscript{149} Id.
\item \textsuperscript{150} Id.
\item \textsuperscript{151} Id.
\item \textsuperscript{152} Hancock \textit{v. Urban Outfitters Inc.}, 830 F.3d 511, 515 (D.C. Cir. 2016).
\item \textsuperscript{153} Id. at 512.
\item \textsuperscript{154} Id.
\item \textsuperscript{155} Id.
\item \textsuperscript{156} Id. at 514.
\item \textsuperscript{157} Id.
\item \textsuperscript{158} Id. (citations omitted).
\item \textsuperscript{159} Id.
\end{itemize}
B. Cases Involving Data Breaches

In cases involving data breaches, many courts continue to follow the general rule stated in Clapper, i.e., that a plaintiff cannot establish standing for “possible future injury” if the threatened injury was not “certainly impending.” However, courts in at least four circuits have held that mitigation costs and an increased risk of future harm may, indeed, qualify as cognizable harm sufficient to confer Article III standing.

1. Courts Finding No Standing

In the consumer class action lawsuit resulting from the Wendy’s breach referenced in Section I of this article, the U.S. District Court for the Middle District of Florida rejected the notion that the threat of future harm could form the concrete injury necessary to establish standing. In Torres v. Wendy’s Co., the plaintiff alleged that shortly after visiting a Wendy’s restaurant in Orlando, Florida, his credit union informed him that someone had attempted to use his debit card at a pair of big-box retail stores. The plaintiff informed his credit union that the charges were fraudulent and his account was refunded.

Roughly a month later, the plaintiff learned of the Wendy’s breach. Concluding that this was the root of the fraudulent charges, the plaintiff brought a putative class action, alleging that The Wendy’s Company had failed to adequately safeguard his and other customers’ information against a breach.

The plaintiff did not allege any out-of-pocket loss, but instead claimed, among other things, that by having his information stolen, he faced the “imminent, immediate, and continuing risk of harm from identity theft and identity fraud.” The district court dismissed for lack of standing.

In reaching its decision, the district court noted that the plaintiff did not suffer any actual monetary loss as the result of the breach because his credit union refunded the fraudulent charges on his card. The court also held that the threat of future fraud or identity theft was too speculative to create the type of injury necessary to establish standing. Citing Clapper, the court noted that for future harm to be sufficient to confer standing, the harm must be “certainly impending.”

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162. Id. at 1280.
163. Id. at 1282.
164. See id. at 1280.
165. Id.
166. Id. at 1281.
167. Id. at 1285.
168. Id. at 1283.
169. Id. at 1285.
170. Id. at 1283.
ditional fraudulent charges and it was unclear at the time how many other customers were impacted.171

The Second Circuit reached a similar conclusion in Whalen v. Michaels Stores, Inc.172 Whalen resulted from the 2013 breach of the Michaels Stores, Inc. POS system, which hackers used to access payment card data belonging to Michaels customers.173 The plaintiff claimed she had used her payment card at a Michaels store around the time of the breach, and based on that fact, brought suit alleging breach of implied contract and violations of New York consumer protection laws.174

The plaintiff asserted three alternative theories of injury: (1) that her credit card information was stolen and used twice in attempted fraudulent purchases; (2) that she faced a risk of future identity fraud as a result of the breach; and (3) that she had lost time and money resolving the attempted fraudulent charges and monitoring her credit.175 The district court dismissed the case for lack of standing.176

On appeal, the Second Circuit affirmed, holding that all three of the plaintiff’s theories failed to establish the concrete injury necessary to establish Article III standing.177 First, the court noted that the plaintiff never actually incurred any of the fraudulent charges; instead, these charges were all covered by her card company’s fraud insurance policies.178 Second, the court explained that the plaintiff immediately canceled her payment cards following the breach and that no other personally identifiable information was alleged to be stolen.179 Finally, the court noted that the plaintiff had failed to plead with specificity the time or effort that she herself has spent monitoring her credit.180

2. Courts Holding That the Threat of Future Harm May Establish Standing

In contrast to courts in the Eleventh and Second Circuits, the D.C. Circuit has been more willing to entertain the idea that the threat of future harm is sufficient to establish standing in a case stemming from a data breach. At-tias v. CareFirst, Inc. related to the 2014 data breach of CareFirst, Inc., which saw a hacker gain access to CareFirst databases containing sensitive customer information.181 The plaintiffs, CareFirst members, filed a class action suit al-

171. Id. at 1284.
173. Id.
174. Id. at 89–90.
175. Id. at 90.
176. Id.
177. Id. at 90–91.
178. Id. at 90.
179. Id. at 90.
180. Id. at 91.
leging, among other things, breach of contract, negligence, and violation of various state consumer protection statutes.\textsuperscript{182} The district court dismissed the case for lack of standing, finding that the risk of injury to the plaintiffs was “too speculative to establish injury in fact.”\textsuperscript{183}

On appeal, the D.C. Circuit reversed, holding that that the plaintiffs’ alleged risk of injury was “substantial” enough to establish standing.\textsuperscript{184} The court noted that it had “frequently upheld claims of standing based on allegations of “substantial risk of future injury” and the proper question to ask at the pleading stage was “whether the complaint plausibly alleges that the plaintiffs now face a substantial risk of identity theft as a result of CareFirst’s alleged negligence in the data breach?”\textsuperscript{185}

Answering this question in the affirmative, the court held that the complaint plausibly alleged that the breach exposed the plaintiffs’ sensitive information—notably, their Social Security and credit card information.\textsuperscript{186} Based on “experience and common sense,” the court noted that plaintiffs would face a substantial risk of identity theft if this sensitive information were accessed by a network intruder.\textsuperscript{187}

Finally, the court distinguished \textit{Clapper}, explaining that the fact pattern in \textit{Attias} was not a “series of contingent events” by “independent actions.”\textsuperscript{188} Instead, the court viewed this situation differently because “an unauthorized party had already accessed personally identifying data on CareFirst’s servers” and it was “much less speculative” to “infer that this party has both the intent and the ability to use that data for ill.”\textsuperscript{189}

The Seventh Circuit has also found the threat of future harm sufficient to establish standing, reasoning that plaintiffs “should not have to wait until hackers commit identity theft or credit card fraud in order to give the class standing.”\textsuperscript{190} \textit{Lewert v. P.F. Chang’s China Bistro} stemmed from the 2014 data breach of the P.F. Chang’s restaurant chain.\textsuperscript{191} As a result of the breach, hackers were able to access the credit and debit card data of many of P.F. Chang’s diners.\textsuperscript{192} Those customers brought a putative class

\textsuperscript{182} Id. at 623.
\textsuperscript{183} Id. at 622.
\textsuperscript{184} Id. at 629.
\textsuperscript{185} Id. at 627 (emphasis in original).
\textsuperscript{186} Id. at 628.
\textsuperscript{187} Id.
\textsuperscript{188} Id. at 628.
\textsuperscript{189} Id. at 628–29 (citing Remijas v. Neiman Marcus Grp., LLC, 794 F.3d 688, 693 (7th Cir. 2015) (“Why else would hackers break into a . . . database and steal consumers’ private information? Presumably, the purpose of the hack is, sooner or later, to make fraudulent charges or assume those consumers’ identities”); see also Galaria v. Nationwide Mut. Ins. Co., 663 F. App’x 384, 388 (6th Cir. 2016).
\textsuperscript{190} Lewert v. P.F. Chang’s China Bistro, Inc., 819 F.3d 963, 966 (7th Cir. 2016).
\textsuperscript{191} Id. at 965.
\textsuperscript{192} Id.
action suit against the restaurant chain. The district court dismissed the suit for lack of standing.

The Seventh Circuit reversed, concluding that the plaintiffs had shown the type of sufficiently imminent harm necessary to establish standing under the *Clapper* test. The court explained:

We identified two future injuries that were sufficiently imminent: the increased risk of fraudulent credit- or debit-card charges, and the increased risk of identity theft. These, we found, were not mere “allegations of possible future injury,” but instead were the type of “certainly impending” future harm that the Supreme Court requires to establish standing.

Although courts have shown a differing willingness to find that the threat of future harm can establish standing, each court’s analysis does appear to include some fact-driven review of the nature of the breach and the intent of wrongdoer.

C. *Another Trip to the Supreme Court?*

The Supreme Court will surely have many opportunities to provide clarity to the deepening split in the circuits, but it is not clear when or if it will venture into this issue again. The *Spokeo* litigation appeared destined for another trip to the Supreme Court; however in January 2018, the Court denied the petition for certiorari in *Spokeo II*. The Court similarly rejected CareFirst’s appeal in *Attias* in February 2018. For the time being, the question of whether standing exists in data privacy cases will be answered on a factual basis, in a case-by-case manner, and will likely be heavily contingent on where the plaintiff files suit.

IV. Conclusion

Developments in technology have created unique opportunities for companies; however, an increased reliance on connectivity entails certain inherent risks. The past decade has seen an alarming jump in data breaches impacting companies, with franchise systems proving to be particularly susceptible.

Judicial uncertainty about how to approach Article III standing in lawsuits resulting from data breaches has added a layer of complexity for companies hoping to establish effective post-breach litigation strategies. In *Clapper* and *Spokeo*, the Supreme Court articulated principles that trial and appellate courts have explored—reaching varying conclusions. While *Clapper* ad-

193. *Id.*
194. *Id.*
195. *Id.*
196. *Id.* at 966.
dressed harms stemming from an alleged data breaches, and Spokeo dealt with claims arising out of statutory violations, we may in the future see cases pled with a variety of claims—for example, a data breach case also involving allegations of statutory breach, which may present even more complex analytic challenges. Although clarity may come from enactment of substantive legislation addressing these issues or from the Supreme Court, franchise companies would be wise to continue monitoring developments and take immediate steps to bolster their comprehensive data protection policies.
Mark Celsi entered into a franchise agreement with H&R Block in 1999 to open a franchise store in Eureka, California. Celsi additionally executed an addendum to the franchise agreement giving him the exclusive right to operate an H&R Block franchise in nearby McKinleyville, California. After a year of success with his H&R Block franchises, Celsi requested the franchisor allow him to open another franchise location in Arcata, a town nestled between Eureka and McKinleyville on California’s northern coast where Celsi had built a book of business. H&R Block declined to extend another franchise to Celsi and instead granted the Arcata franchise to a third party.

Nearly a decade after first executing the franchise agreement and addendum, Celsi filed suit against H&R Block alleging, among other things, that the franchisor breached the franchise agreement and committed fraud.

2. Id. at *1.
3. Id. at *2.
4. Id.
by refusing him the Arcata franchise.⁵ To support his claim, Celsi alleged that he received multiple oral assurances regarding his right to eventually open an H&R Block franchise in Arcata during the negotiation of the franchise agreement and addendum.⁶

In any typical situation where a franchisor and franchisee have reduced an agreement to a written document, and especially where the agreement includes an integration or merger clause, courts employ the parol evidence rule (the Rule) to block the admission of extrinsic oral and written evidence concerning the terms or nature of the agreement. The Rule’s rationale is simple—in cases like the one between Celsi and H&R Block, the terms of a proposed agreement often vary greatly over the course of the parties’ negotiations; therefore, the written franchise agreement in which the parties memorialized their intentions provides the best evidence of the agreement the parties actually intended to make.⁷

Celsi, however, hoped to take advantage of one of the Rule’s well-known exceptions—the exception for fraud. Many jurisdictions allow a party to introduce oral and written evidence that directly contradicts the terms of a contract to show fraud in the contract itself or that one of the parties fraudulently induced the other to enter into the agreement in the first place. In this instance, the relevant statute of limitations precluded Celsi’s claim and saved the tax-preparation giant from having to defend against allegations of nearly ten-year-old oral misrepresentations.⁸ Nevertheless, Celsi’s fraud claim gives but one illustration of how the Rule’s exceptions create vulnerabilities for franchisors.⁹

In situations where a franchise relationship breaks down, and in other disputes where the terms of a franchise agreement are at issue, the parol evidence rule serves as a helpful shield for franchisors that must defend themselves against allegations their actions led to the failure of the franchise or harmed the franchisee. The Rule works with well-drafted integration and merger clauses as an important first step to protecting the terms of a fran-

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5. Id.
6. Id. at *3.
7. Town Bank v. City Real Estate Dev., LLC, 793 N.W.2d 476, 486 (Wis. 2010) (explaining that the parol evidence rule’s “principle stems from basic contract law: if the contract is unambiguous, the court’s attempt to determine the parties’ intent ends with the language of the contract, without resort to extrinsic evidence”).
8. Celsi, 2012 WL 2914293, at *3. The court pointed out that the California Franchise Investment Law requires that fraud claims be brought within two years of when the alleged misrepresentation was made. Celsi unsuccessfully tried to argue that H&R Block’s promises that he could open an Arcata franchise location only became fraudulent once H&R Block actually refused his request for a franchise. Notably, shortly after Celsi, the California Supreme Court broadened the application of the fraud exception to the Rule in Riverisland Cold Storage, Inc. v. Fresno-Madera Production Credit Ass’n, 291 P.3d 316, 324 (Cal. 2013).
chise agreement. However, as useful as the parol evidence rule may be for franchisors, courts recognize some major exceptions to the Rule. Additionally, some courts and legislatures have limited the parol evidence rule’s application and reach, leaving even careful franchisors exposed to disgruntled franchisees’ claims. Given these limitations, franchisors must carefully draft franchise agreements that include all important provisions, agreements, understandings, and representations.

This article will review the parol evidence rule and its application to franchise relationships. The article will first provide an overview of the Rule. Next, it will consider the major exceptions to the Rule and when parol evidence has been admitted by courts. Third, the article will consider other limitations, including statutory issues, to the Rule. Fourth, the article will outline some steps that franchisors can take to protect themselves in light of these limitations.

I. The Parol Evidence Rule: An Overview

A franchise agreement is a contract like any other. The franchise agreement seeks to memorialize and give precise terms to the agreement and business relationship between the franchisor and franchisee. Franchise agreements often are the result of significant negotiations and deliberations between the parties. After the bargaining and shifting positions of negotiations, the process of memorializing an agreement gives an element of finality to and establishes the boundaries of the parties’ understanding. Courts interpreting franchise agreements employ the ordinary substantive rules, tools of construction, and rules of interpretation that they would for any other type of contract.10

The Rule is a long-standing, court made rule that provides extrinsic evidence cannot be introduced to contradict or explain the provisions of a written contract because the written contractual document itself provides the best evidence of its terms and the parties’ intentions.11 In 1857, the Supreme Court explained, “[i]t is admitted that the general rule of the common law is, that it is not competent by parol evidence to alter, vary, or change a written instrument in its essential terms[.]”12 The Rule applies to exclude extrinsic evidence only if the contract at issue is integrated—if it manifests the com-

10. SeeRestatement (Second) of Contracts § 213 (1981) (explaining that the parol evidence rule is not a rule of evidence or interpretation, but one of substantive law).
11. SeeBank of U.S. v. Dunn, 31 U.S. 51, 57 (1832) (“This court, in the case of Renner v. The Bank of Columbia, 9 Wheat. 587, in answer to the argument that the admission of proof of the custom or usage of the bank would go to alter the written contract of the parties, say, ‘if this is the light in which it is to be considered, there can be no doubt that it ought to be laid entirely out of view: for there is no rule of law better settled, or more salutary in its application to contracts, than that which precludes the admission of parol evidence, to contradict or substantially vary the legal import of a written agreement.’”).
plete and final expression of the agreement. A contract is “fully integrated” when the written document agreed to by the parties supersedes the parties’ earlier agreements.

Parties desire an integrated contract for a simple reason: it clarifies the expectations, desires, rights, and responsibilities of the parties and distills them into a single source. Additionally, these boundaries make the contractual agreement much harder to attack later in the event the parties’ relationship or the circumstances have changed. For these reasons, franchisors regularly include clauses stipulating the parties intend to form a fully integrated agreement.

To signal that contracts, including franchise agreements, constitute the parties’ fully integrated agreement, parties regularly use contractual provisions called “integration” or “merger” clauses. Parties employ these clauses to achieve simple ends: to protect agreements from later attack with parol evidence by limiting consideration of evidence in a contractual dispute to the written agreement signed by the parties. An integration or merger clause achieves this by stipulating that the entirety of a particular agreement is included in the contractual document. As one court explained, these clauses “prohibit the introduction of parol evidence introduced to revise or contradict the terms of a written contract. . . . [They] bar evidence of earlier agreements because the law presumes that a contract represents the final expression of the parties’ bargaining.” Courts have also described merger clauses as acting to eviscerate “collateral agreements or understandings between two parties that are not expressed in a written contract.” Although a few courts require that these provisions be specific to the parties and not simply “boilerplate” additions to the franchise agreement, courts reliably en-

13. Williams v. Spitzer Autoworld Canton, L.L.C., 913 N.E.2d 410, 415 (Ohio 2009) (“The parol evidence rule provides that absent fraud, mistake or other invalidating cause, the parties’ final written integration of their agreement may not be varied, contradicted or supplemented by evidence of prior or contemporaneous oral agreements, or prior written agreements.”) (citation omitted).


15. Black’s Law Dictionary defines an integration clause as: “A contractual provision stating that the contract represents the parties’ complete and final agreement and supersedes all informal understandings and oral agreements relating to the subject matter of the contract.” Black’s also suggests that merger clauses are synonymous. See Integration Clause, BLACK’S LAW DICTIONARY (10th ed. 2014).


17. RESTATEMENT (SECOND) OF CONTRACTS § 210 (1981) (“(1) A completely integrated agreement is an integrated agreement adopted by the parties as a complete and exclusive statement of the terms of the agreement.”).


force integration and merger clauses. The U.S. District Court for the Western District of Wisconsin artfully described the burden that a party seeking to introduce parol evidence faces when confronted with an unambiguous integration clause: “[t]he franchise agreement’s pellucid integration clause confronts defendants’ breach of contract claim like a hors catégorie climb on a ‘fixie.’” Said differently, franchisees seeking to attack a fully integrated franchise agreement with parol evidence face a steep hill to climb.

Because integration or merger clauses stipulate that all prior understandings and agreements between the contracting parties are merged into the contract at issue, their inclusion in a franchise agreement can prevent a party from showing that extra-contractual promises or agreements ever existed. In Stone Motor Co. v. General Motors Corp., for example, the Eighth Circuit held that due to a franchise agreement’s unambiguous merger clause, pre-franchise documents, including the franchise application, were inadmissible parol evidence. As a result, the court refused to allow the franchisee to introduce the franchise application as evidence that the franchisor promised to provide it particular types and numbers of vehicles. However, because the Rule only bars evidence that addresses the same subject matter as the written franchise agreement, a merger clause will not always block evidence of collateral or additional agreements.

II. Exceptions to the Parol Evidence Rule

A. Overview

As noted, the Rule exists to protect the parties’ bargained-for agreement by broadly disallowing oral and written extrinsic evidence to contradict the written agreement or interpret its meaning. However, courts continue to recognize several long-standing exceptions to the Rule to ensure equitable results in disputes between parties to a contract. As the Supreme Court explained in 1823,

[j]t is a general rule, that an agreement in writing, or an instrument carrying an agreement into execution, shall not be varied by parol testimony, stating conver-

21. ERA Franchise Sys., LLC v. Hoppens Realty, Inc., No. 12-CV-594-SLC, 2013 WL 3967869, at *6 (W.D. Wis. July 31, 2013) (explaining that when a court encounters a contract containing an unambiguous merger or integration clause, the court is barred from considering evidence of any prior or contemporaneous understandings or agreements between the contracting parties. This principle extends to the issue of integration itself.).
22. 293 F.3d 456 (8th Cir. 2002).
23. Id. at 466.
25. See, e.g., RESTATEMENT (SECOND) OF CONTRACTS § 213 (1981) (“(1) A binding integrated agreement discharges prior agreements to the extent that it is inconsistent with them. (2) A binding completely integrated agreement discharges prior agreements to the extent that they are within its scope.”).
sations or circumstances anterior to the written instrument. ... This rule is rec-
goognised in Courts of equity as well as in Courts of law; but Courts of equity grant relief in cases of fraud and mistake, which cannot be obtained in Courts of law. In such cases, a Court of equity may carry the intention of the parties into execution, where the written agreement fails to express that intention. 26

The most common court-made exceptions to the Rule are in cases where (1) one of the parties alleges fraud (including fraudulent concealment); (2) the written document is deemed to be ambiguous in certain ways; or (3) the parol evidence is used to show a mistake or error made by the parties. Professor Corbin’s treatise notes that “[i]t is widely agreed that oral testimony is admissible to prove fraud or misrepresentation, mistake, or illegality. This exception to the parol evidence rule applies even if the testimony contradicts the terms of a completely integrated writing.” 27 The logic of these exceptions is that they provide evidence helpful to show the true intention of the parties and the nature of the agreement they meant to form. Courts should not fear admitting parol evidence in these circumstances because “[w]hen incidents of fraud, innocent misrepresentation or mistake precede an integration, they clearly were not bargained over, and thus proof of them should never be barred by a merger clause or other application of parol evidence.” 28 Importantly, the Rule does not prevent the admission of parol evidence for purposes that do not intend to explain or contradict the written agreement. 29 The following sections explore the application of these various exceptions to the Rule in the franchise context.

B. Fraud

It is not uncommon for aggrieved franchisees to assert fraud-related claims against franchisors. These claims come in a variety of forms, but generally share a common theme—the franchisor made promises, statements, or implications, or failed to disclose certain facts, and thereby induced the franchisee to enter into the franchise agreement. Most fraud claims involve both the alleged wrongful action by the franchisor and some sort of detrimental reliance by the franchisee. 30 As one court explained, the Rule exists to protect the actual agreement that the parties negotiated for—that the parties do not negotiate for fraud justifies the fraud exception. 31

27. 6 Corbin on Contracts § 25.20[A] (rev. ed. 2009).
28. Id. § 25.20[B][3].
29. See, e.g., Cox v. Doctor’s Assoc., Inc., 613 N.E.2d 1306, 1321 (Ill. App. Ct. 1993) (holding that the trial court did not err in admitting parol evidence of promises made to the franchisee by the franchisor that did not contradict the franchise offering circular, the promotional brochure, or the franchise agreement).
31. Id. at *7 (quoting 6 Corbin on Contracts § 25.20[B][3]) (rev. ed. 2009).
Different jurisdictions treat the fraud exception to the Rule differently. Until recently, for example, California did not allow the admission of parol evidence to prove fraud if the evidence directly contradicted the written agreement.\textsuperscript{32} Jurisdictions also differ on whether the Rule applies to claims for fraud in the inducement.\textsuperscript{33} Some courts refuse to recognize an exception for a fraud in the inducement claim, but readily admit parol evidence when the franchisee is making a fraud in factum claim.\textsuperscript{34} Other courts additionally require a showing that the franchisee’s reliance on the alleged fraudulent misrepresentation or concealment of fact was reasonable or justified.\textsuperscript{35} In Colorado, for example, the franchisee must show both that it relied on the franchisor’s misrepresentation and also that it was justified in doing so.\textsuperscript{36}

Franchisors frequently defend themselves from fraudulent misrepresentation claims founded on the materials and information exchanged prior to executing a fully integrated franchise agreement. Generally, these claims state that the franchisor made false representations of fact that induced the franchisee to enter into the franchise agreement. In \textit{Cottman Transmission Systems, LLC v. Kershner}, for example, a franchisee accused Cottman of making mis-

\textsuperscript{32} See, e.g., Traumann v. Southland Corp., 842 F. Supp. 386 (N.D. Cal. 1993) (holding, “[t]he Traumanns’ fraud claims are barred by the parol evidence rule. Under California law, ‘if the false promise relates to the matter covered by the main agreement and contradicts or varies the terms thereof, any evidence of the false promise directly violates the parol evidence rule and is inadmissible.’” [citation omitted]). \textit{But see Riverisland Cold Storage, Inc. v. Fresno-Madera Prod. Credit Ass’n}, 291 P.3d 316, 324 (Cal. 2013). In \textit{Riverisland}, the California Supreme Court broadened the fraud exception to the Rule to allow parol evidence proving fraud, even if that parol evidence directly contradicted the written agreement. The court explained that “[w]hen fraud is proven, it cannot be maintained that the parties freely entered into an agreement reflecting a meeting of the minds.” \textit{Id}. California’s current application of the fraud exception now matches most jurisdictions in this sense and the court referred to its previous precedent as an “aberration.” \textit{Id}.

\textsuperscript{33} See, e.g., Keller v. A.O. Smith Harvestore Prods., 819 P.2d 69, 73 (Colo. 1991) (fraud in the inducement claims are generally not subject to the Rule); L.A. Ins. Agency Franchising, LLC v. Montes, No. CV 14-14432, 2016 WL 922948, at *9 (E.D. Mich. Mar. 11, 2016) (citing Custom Data Solutions, Inc. v. Preferred Capital, Inc., 733 N.W.2d 102, 105 (Mich. Ct. App. 2006) (“This case, then, is governed by the rule that the presence of a merger clause in a written contract will not preclude a claim for fraud in the inducement where the plaintiff can show that it would have avoided the agreement entirely had it known that the defendant’s fraudulent misrepresentations in fact were false.”)).

\textsuperscript{34} See Yocca v. Pittsburgh Steelers Sports, Inc., 854 A.2d 425, 437 (Pa. 2004) (“Notably, while parol evidence may be introduced based on a party’s claim that there was fraud in the execution of the contract, i.e., that a term was fraudulently omitted from the contract, parol evidence may not be admitted based on a claim that there was fraud in the inducement of the contract, i.e., that an opposing party made false representations that induced the complaining party to agree to the contract.”).

\textsuperscript{35} See Ayu’s Global Tire, LLC v. Big O Tires, LLC, No. B236930, 2013 WL 2298585 (Cal. Ct. App. May 24, 2013); \textit{see also} Star Ins. Co. v. United Commercial Ins. Agency, Inc., 392 F. Supp. 2d 927, 929 (E.D. Mich. 2005) (“The key element in cases involving a merger clause is whether one justifiably relied on the representations of another when the parties’ written agreement clearly stated that by signing the document they were agreeing that the document made up the parties’ entire agreement regarding the terms of the contract and its performance standards.”).

representations in its Uniform Franchise Offering Circular (UFOC).\textsuperscript{37} Specifically, the franchisees claimed the franchisor “misrepresented the average profit made by franchise store owners, the number of Cottman franchise stores that had closed in the past, the experience necessary to operate a franchise, and the average sales of franchise stores.”\textsuperscript{38} The court ultimately rejected the franchisee’s attempt to use the UFOC to substantiate its fraud claim because the franchise agreement included a merger clause stipulating that the franchisees were not relying on any representations made outside the contract.\textsuperscript{39} Similarly, courts are more likely to reject fraud claims where the franchise agreement itself addresses the same subject matter as the alleged misrepresentations predating the agreement.\textsuperscript{40} Some courts provide that it is unreasonable to rely on a pre-contractual fraudulent misrepresentation regarding a particular topic when the fully integrated franchise agreement authoritatively provides information on that topic.\textsuperscript{41}

With claims of silent fraud or fraudulent concealment, franchisees often allege that the franchisor failed to disclose or suppressed important or crucial information that the franchisee should have known prior to entering into the franchise agreement.\textsuperscript{42} The Michigan Court of Appeals described silent fraud as involving “information that has been deliberately and deceptively withheld by one of the contracting parties.”\textsuperscript{43} In \textit{Abbo v. Wireless Toyz Franchise, LLC}, the court of appeals affirmed the admission of parol evidence of the franchisor’s deliberate suppression of information related to the UFOC.\textsuperscript{44} However, the court noted that silent fraud may include failing to meet a duty to disclose.\textsuperscript{45} The court reasoned that the franchisor had a duty to disclose data to correct otherwise misleading information in the UFOC and that the franchisor’s non-disclosure constituted fraud.\textsuperscript{46} Despite a merger clause in the parties’ franchise agreement, the fraud warranted an exception to the Rule and the admission of the UFOC: “merger clauses do not mechanically eliminate from consideration \textit{all} precontractual state-
ments or representations. A party may present evidence that deceit induced a contract, thereby rendering the agreement void.\textsuperscript{47}

Courts also distinguish between the types of representations that are within the contract’s scope (and are therefore protected by a merger clause) and those that are outside of the contract’s scope.\textsuperscript{48} As the U.S. District Court for the Eastern District of Michigan explained, “a party could still justifiably rely upon representations made by another party regarding things outside the scope of the contractual terms, such as the other party’s solvency, indebtedness, experience, clientele, client retention rate, business structure, etc. If these representations are false when they are made, not merely opinion and not future promises, they could constitute fraud in the inducement.”\textsuperscript{49}

C. Ambiguity

Another common exception to the Rule occurs when a contract contains an ambiguity. Courts may deem a contract or a provision of a contract ambiguous when “a reasonably intelligent person viewing the contract objectively could interpret the language in more than one way.”\textsuperscript{50} In such cases, courts may admit extrinsic evidence to resolve the ambiguity. However, courts are reluctant to find contractual ambiguity if the language of the contract can provide its own explanation.\textsuperscript{51} In \textit{Bayit Care Corp. v. Tender Loving Care Health Care Services}, for example, the U.S. District Court for the Eastern District of New York rejected a franchisee’s insistence that allegedly inconsistent language in a five-year extension agreement displaced the renewal provision in the original franchise agreement.\textsuperscript{52} Instead, the court determined that the original franchise agreement was clear on its face with respect to the disputed provision and applied the original franchise agreement.\textsuperscript{53}

Conversely, in a conflict regarding royalty rates in \textit{Coyote Portable Storage, LLC v. PODS Enterprises, Inc.}, the U.S. District Court for the Northern District of Georgia admitted parol evidence after the court found an ambiguity in the parties’ intent concerning the definition of “net sales” and its calculation.\textsuperscript{54} The court observed that conflicts in language between an original

\textsuperscript{47.} \textit{Id.} (citing Custom Data Solutions, Inc. v. Preferred Capital, Inc., 733 N.W.2d 102 (Mich. Ct. App. 2006) (emphasis in original)).


\textsuperscript{49.} \textit{Id.}

\textsuperscript{50.} \textit{Topps Co., Inc. v. Cadbury Stani S.A.I.C.,} 526 F.3d 63, 68 (2d Cir. 2008).

\textsuperscript{51.} \textit{See Bayit Care Corp. v. Tender Loving Care Health Care Servs.,} No. 11-CV-3929 DRH, 2012 WL 1079042, at *7 (E.D.N.Y. Mar. 30, 2012) (quoting Garza v. Marine Transp. Lines, Inc., 861 F.2d 23, 26-27 (2d Cir. 1988) (“The parol evidence rule aims to ensure some measure of stability in commercial relations. . . . In the absence of the ambiguity, the effect of admitting extrinsic evidence would be to allow one party to substitute his view of his obligations for those clearly stated.”)).

\textsuperscript{52.} \textit{Bayit Care Corp.,} 2012 WL 1079042, at *7.

\textsuperscript{53.} \textit{Id.}

franchise agreement and its addendum created an ambiguity as to the intent of the parties, justifying the admission of parol evidence.55 Similarly, in Stul-ler, Inc. v. Steak ‘n Shake Enterprises, the U.S. District Court for the Central District of Illinois considered whether a franchise agreement’s provision allowing the franchisor to revise “the System” included the ability to set menu prices at the franchises.56 The court found that the phrase “the System” in the franchise agreement was ambiguous and admitted parol evidence, including previous agreements, negotiations, and UFOCs.57

D. Mistake, Accident, and Party Admission Exceptions

Mistake is another longstanding exception to the Rule.58 When a franchise agreement fails to capture the parties’ intent, courts will admit parol evidence for the purpose of identifying the intent. “In addition, where the actual intent of the parties is disputed or it is alleged that the language, while clear on its face, was the result of a mutual mistake of the parties, parol evidence is admissible to determine the true intent of the parties.”59 In Patton v. Mid-Continent Systems, for example, the Seventh Circuit held that despite a franchise agreement’s integration clause, parol evidence from the parties’ negotiations was admissible to resolve a territorial dispute when the scope of the territory was accidentally left out of the franchise agreement by the parties.60

Some states also recognize an “admissions” exception to the Rule. Generally, the Rule blocks the admission of extrinsic evidence that is contrary to the written agreement, but as the Third Circuit explained, that rule does not apply if a party admits that the written contract does not set forth the whole of the agreement.61 In Domino’s Pizza v. Deak, the court weighed whether the franchisee should be allowed to introduce the testimony of a former Domino’s executive. In her testimony, the former executive explained that a separate oral agreement, entitling the franchisee to continue to renew its franchise agreement, existed.62 Notwithstanding Domino’s oppo-

55. Id. (citing Danforth Orthopedic Brace & Limb, Inc. v. Florida Health Care Plan, Inc., 750 So. 2d 774, 776 (Fla. Dist. Ct. App. 2000)).
57. Id. at 692–94.
58. See, e.g., Hunt v. Rousmanier’s Adm’rs, 21 U.S. 174, 216 (1823) (“We find no case which we think precisely in point; and are unwilling, where the effect of the instrument is acknowledged to have been entirely misunderstood by both parties, to say, that a Court of equity is incapable of affording relief.”).
60. 841 F.2d 742, 746 (7th Cir. 1988).
61. Domino’s Pizza LLC v. Deak, 383 F. App’x 155, 159 (3d Cir. 2010) (explaining, “[t]he parol evidence rule bars the admission of material contrary to the express terms of the written agreement, ‘unless it is admitted that the whole of the agreement is not set forth in the writing.’ . . . The admission of incompleteness must have been made or alleged to have been made at a time subsequent to entering into the agreement.”).
62. Id.
tion, the court held the franchisee should be allowed to submit and that the district court should consider the admission evidence. 63

III. Further Limitations to the Parol Evidence Rule

Statutory measures may weaken the protection provided to franchisors by the Rule. Specifically, in an effort to level the playing field between parties to franchise agreements, some state statutes include provisions that may nullify the integration, merger, or non-reliance clauses included in the agreements. Thus, despite including such clauses in their agreements, franchisors cannot ensure that courts will not later admit evidence of other materials or representations made during pre-agreement negotiations.

In Atchley v. Pepperidge Farm, for example, the U.S. District Court for the Eastern District of Washington fielded claims for negligent misrepresentation and violations of Washington’s Franchise Investment Protection Act (FIPA). 64 FIPA imposes an affirmative duty on franchisors to avoid inducing a franchisee’s reliance on untrue oral or written statements or omissions of material facts. 65 In Atchley, the plaintiff franchisee accused the defendant franchisor of making oral misrepresentations. Although the court noted that the Rule potentially barred evidence of the alleged oral misrepresentations for purposes of the negligent misrepresentation claim, the court also pointed out that this evidence could be admissible for a claim under FIPA. 66 The court even implied that the statute’s non-waiver provision potentially stripped away the integration and non-reliance clauses that the franchisor built into the franchise agreement: “to the extent Defendant holds out the contractual integration and non-reliance clauses to immunize itself against liability for any misleading oral misrepresentations or omissions, FIPA may void those contractual provisions for attempting to waive Defendant’s obligations under [the statute].” 67

63. Id. (To justify admitting the parol evidence for an otherwise integrated contract, the Third Circuit pointed to Pennsylvania’s interpretation of the Rule: “the parol evidence rule has never barred the introduction of clear, precise, and convincing evidence to show that the party who seeks to enforce the written agreement according to its tenor has admitted and acknowledged that the agreement as written did not express what the parties intended and what the parties intended was omitted from the agreement by mistake or accident.” (quoting Scott v. Bryn Mawr Arms, Inc., 312 A.2d 592, 595 (Pa. 1973))).
65. See WASH. REV. CODE § 19.100.170 (“It is unlawful for any person in connection with the offer, sale, or purchase of any franchise or subfranchise in this state directly or indirectly: (1) To make any untrue statement of a material fact in any application, notice, or report filed with the director under this law or willfully to omit to state in any application, notice or report, any material fact which is required to be stated therein or fails to notify the director of any material change as required by RCW 19.100.070(3).”).
67. Id. (citing Rutter v. BX of Tri-Cities, Inc., 806 P.2d 1266, 1268 (Wash. Ct. App. 1991)).
Other states have adopted similar statutory schemes that are designed to give franchisees a stronger position vis-à-vis their franchisors. Like Washington, Michigan imposes certain duties on franchisors. The Michigan Franchise Investment Law (MFIL) “imposes on franchisors a statutory obligation to refrain from making material misrepresentations and omitting pertinent information from any disclosures.” In addition to the mandatory informational disclosures required by the statute, the MFIL also includes a list of void and unenforceable provisions that may not be included in a franchise agreement. California’s Franchise Investment Law imposes similar duties on the franchisor. If the franchisor violates any of the provisions in the California statute, including making fraudulent misrepresentations or failing to make required disclosures, the statute subjects the franchisor to liability to the franchisee.

In some circumstances, states have even adopted industry-specific franchise statutes. Missouri, for example, is one of many states that has a motor vehicle franchise practices statute.

However, even in states that have adopted robust franchise statutory schemes, not all of them are as franchisee-friendly as the Washington statute. The Florida Franchise Act, for example, does not contain an anti-waiver provision, which means that parties may contract around the protections provided by the statute. Considering the variety of statutory schemes throughout American jurisdictions, franchisors seeking to include strong protections against parol evidence in their franchise agreements should ensure that the desired provisions are enforceable in their jurisdiction.

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68. See, e.g., Virginia Retail Franchise Act, VA. STAT. § 13.1-558 (explaining Virginia’s public policy to “correct as rapidly as practicable such inequities as may exist in the franchise system”); see also Illinois Franchise Disclosure Act (IFDA), 815 ILL. COMP. STAT. 705/1 et seq.

69. MICH. COMP. LAWS ANN. § 445.1501 et seq.


71. MICH. COMP. LAWS ANN. § 445.1527.

72. See CAL. CORP. CODE § 31000 et seq.

73. CAL. CORP. CODE § 31201 (covering particular misrepresentations or omissions); see also CAL. CORP. CODE § 31301 (“[A]ny person who violates section 31201 shall be liable to any person (not knowing or having cause to believe that such statement was false or misleading) who, while relying upon such statement shall have purchased a franchise, for damages, unless the defendant proves that the plaintiff knew the facts concerning the untruth or omission or that the defendant exercised reasonable care and did not know (or if he had exercised reasonable care would not have known) of the untruth or omission.”).

74. See Motor Vehicle Franchise Practices Act, MO. REV. STAT. § 407.810-835 (1997); Stone Motor Co. v. Gen. Motors Corp., 293 F.3d 456 (8th Cir. 2002) (“The purpose of the MVFPA is to level the contractual playing field between local franchisees and motor vehicle manufacturers.”).

75. See FLA. STAT. § 817.416; Cottman Transmission Sys., LLC v. Kershner, 536 F. Supp. 2d 543 (E.D. Pa. 2008) (“Because the Franchise Act contains no anti-waiver provision, Florida franchisees may choose to contract around the Act. In other words, Florida’s policy is to provide a franchisee with as much protection as he or she contracts to receive.”)
IV. What Can Franchisors Do?

To start, franchisors can avoid at least some of their franchisees’ claims by complying with state and federal franchise disclosure requirements. As discussed above, multiple states regulate franchising through a variety of statutory schemes. These statutory regimes generally provide what disclosures must be made to prospective franchisees, and many of these states require that pre-franchise agreement materials be provided to a state regulatory agency. Importantly, these state statutes often provide to franchisees a private right of action against a franchisor that fails to properly comply with the required disclosures. Additionally, franchisors are similarly bound by federal regulation to provide prospective franchisees with the appropriate disclosures. The federal disclosure requirements, promulgated by the Federal Trade Commission, supplement any existing state laws directing disclosure. Although the FTC Rule does not provide a private right of action like the state statutes, it does serve as “a siren call for franchisees looking for a good cause of action.” In other words, franchisees may use a violation of the FTC Rule as the basis for a claim in states that do not have a statute regulating disclosures.

Outside of the disclosures required by statute or regulation, if a franchisor wants to make certain representations or provide significant information to a potential franchisee prior to executing the franchise agreement, the franchisor should assess the necessity of this information. When communicating with potential franchisees, franchisors should take affirmative steps to ensure that potential franchisees have access to adequate and accurate information about the franchise. By supplying prospective franchisees with more information, franchisors can prevent later claims of fraudulent concealment, or silent fraud, and fraudulent misrepresentation. This is especially true in states that require a plaintiff franchisee to prove reasonable reliance.

In providing pre-agreement materials for prospective franchisees, franchisors should include disclaimers that urge the prospective franchisees not to rely on the given data and to conduct their own due diligence. In *Colorado Coffee Bean LLC v. Peaberry Coffee Inc.*, for example, a franchisor issued a
UFOC disclosing gross sales at established stores, but warned that it made no guarantee of profitability and provided no data regarding profits. The UFOC also encouraged prospective franchisees to conduct their own independent financial analyses. The franchisee ultimately brought a fraudulent nondisclosure claim, alleging the franchisor should have disclosed losses at existing franchise stores. Because of the language in the UFOC and the clear language in the franchise agreement, the Colorado Court of Appeals held that the franchisee failed to prove reasonable reliance on the purported fraudulent nondisclosures.

When drafting an integration or merger clause, or other franchise agreement disclaimers, franchisors should ensure that the clauses are broad enough to exclude the pre-contractual statements and negotiations between themselves and their franchisees. In Abbo, for example, the Michigan Court of Appeals parsed the language in a merger clause and allowed parol evidence substantiating that the franchisor “fraudulently concealed” damaging information. The court first observed that although the merger clause in the franchise agreement applied to “any and all prior or contemporaneous agreements” and “all previous written and oral agreements or understandings between the parties,” it did not apply to any prior “representations” or “inducements.” Citing the plain language of the merger clause, the court admitted the parol evidence, pointing out that it did not contradict the terms of the franchise agreement.

Conversely, the franchisor in Maaco Franchising, Inc. v. Tainter included an integration clause sufficiently broad enough to protect a franchise agreement’s forum selection clause from attack with parol evidence. The franchise agreement provided that “[n]o representations, inducements, promises, or agreements, oral or otherwise, not embodied herein or attached hereto (unless of subsequent date) are made to either party, and none shall be of any force or effect with reference to this Agreement or otherwise.” The court found that this language negated a separate franchise disclosure document that the franchisor gave to the franchisee before the execution of the franchise agreement, which suggested that some California law may supersede certain terms of the agreement.

83. Id.
84. Id. at 18.
85. Id. at 20.
87. Id.
88. Id.
90. Id. at *1–2.
91. Id. at *4.
When drafting the franchise agreement, franchisors should keep a few other considerations in mind. First, where possible, franchisors should seek to avoid “boilerplate” integration and merger clause language in the franchise agreement and should instead opt for language tailored to the parties’ needs. Kansas courts, for example, have held that boilerplate integration clauses fail to bar parol evidence of oral representations made by a franchisor during negotiations.\footnote{92. See Ramada Franchise Sys., Inc. v. Tresprop, Ltd., 188 F.R.D. 610, 615–16 (D. Kan. 1999); see also Genesis Health Clubs, Inc. v. LED Solar & Light Co., No. 13-CV-1269, 2013 WL 5276150, at *5 (D. Kan. Sept. 18, 2013). In Vermont, courts have similarly explained that “boilerplate integration clauses and disclaimers will not, as a rule, preclude a claim of fraudulent inducement based on statements not contained in the contract.” See Sherman v. Ben & Jerry’s Franchising, Inc., No. 1:08-CV-207, 2009 WL 2462339, at *3 (D. Vt. Aug. 10, 2009) (citing Negessy v. Strong, 556 A.2d 81, 83 (Vt. 1978)).} Second, franchisors should include disclaimers in the franchise agreement that limit the franchisee’s reliance on any representations that are not made in the franchise agreement itself.\footnote{93. See Sherman, 2009 WL 2462339, at *4. As the court explained, “[w]here a seller expressly disclaims any express or implied warranty concerning specific representations, and a buyer expressly acknowledges the disclaimer and the need to conduct an independent investigation, that party may not sue on a claim she was defrauded into entering the contract in reliance on those very representations.”} Lastly, separate closing acknowledgments may also help bolster the integration and merger clauses in a franchise agreement.\footnote{94. See, e.g., Ayu’s Global Tire, LLC v. Big O Tires, LLC, No. B236930, 2013 WL 2298585, at *7 (Cal. Ct. App. May 24, 2013) (franchisee executed a separate closing acknowledgment that stated “I am not relying on any promises of [franchisor] which are not contained in the Big O franchise agreement.” (citing Sugarline Assocs. v. Alpen Assocs., 586 A.2d 1115 (Vt. 1990)).}

Taking a few preventative steps during the negotiation and drafting of the franchise agreement helps franchisors defend the terms of the franchise agreement from attack with parol evidence.

V. Conclusion

Franchise agreements are intended to fully define the franchisor’s and franchisee’s relationship and designate their rights and responsibilities. As with most contracts, franchise agreements typically aim to serve as the fully integrated agreement between the parties. The Rule serves to protect these agreements from later attack by the franchisee. Whether it is because the circumstances surrounding the franchise and/or the franchise relationship have changed or because one of the parties later seeks more favorable terms than those outlined by the franchise agreement, the Rule plays an important role in preserving the original intention of the contracting parties.

However, long-standing and significant exceptions to the Rule provide tools for courts to ensure equity and fairness in the franchise relationship. By providing exceptions for fraud, ambiguity, and mistake, courts can effectuate the parties’ intent and ensure fair dealing in franchise agreements. Ad-
ditionally, the adoption of robust franchise statutory schemes potentially weakens the shield that the Rule provides to franchise agreements.

Well-drafted integration and merger clauses provide franchisors with an important first line of defense for the franchise agreement. Yet, in view of the Rule’s significant exceptions, franchisors must be careful to ensure that the franchise agreement sets forth all important provisions, agreements, understandings, and representations. Franchisors may also mitigate the possibility of conflict by including certain disclaimers in pre-contractual documents and by producing consistent representations in UFOCs and in the franchise agreement itself. These and other steps help alleviate the vulnerabilities created by the exceptions to the Rule.
Liquidated Damages Provisions: Strategic Drafting and Enforcement Issues

Benjamin B. Reed

I. Introduction

The Spring 2010 issue of the Franchise Law Journal featured an excellent and thorough article authored by Deb Coldwell, Altresha Burchett-Williams, and Melissa Celeste that surveyed the laws of each state regarding the enforceability of liquidated damages provisions. The legal standards have not changed significantly in the intervening years, and many franchise litigators (author included) refer to that article in preparing to brief the enforceability of these provisions. However, as any litigator will tell you, there is more to enforcing a contract term than simply stating the legal standard. There are many other factors to consider when litigating the enforceability of a liquidated damages provision in a franchise agreement. After briefly summarizing the applicable legal standards, this article examines the considerations for drafting an enforceable liquidated damages provision, the arguments and evidence that have satisfied the applicable standard, the arguments and evidence that courts have considered in refusing to enforce liquidated damages provisions, and certain procedural issues that can arise in enforcement efforts.

II. The Legal Standard, Generally Speaking

The 2010 Franchise Law Journal article on liquidated damages included a chart that summarized the standard each state applies when determining whether or not a liquidated damages provision is enforceable. We will

3. Coldwell et al., supra note 1, at 218–30.

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not endeavor to reinvent that wheel here. However, in general terms, the standard is relatively similar from state to state.\(^4\) In examining whether a liquidated damages provision is enforceable, courts will generally look at whether: (1) the parties intended to liquidate damages; (2) when the contract was made, the amount of liquidated damages specified was a reasonable estimate of the presumed actual damages that a breach would cause; and (3) when the contract was made, the amount of actual damages that would result from a breach was difficult to determine.\(^5\) Liquidated damages provisions are more likely to be considered reasonable if damages would be more difficult to ascertain.\(^6\) However, the amount of the liquidated damages must be reasonably proportional to the amount of probable damage that will result from a breach.\(^7\) Liquidated damages that are deemed penalties—because they are not a reasonable estimate of the probable damage arising from a breach—are not enforceable as a matter of public policy.\(^8\)

The differences in how courts evaluate liquidated damages provisions turn on how the generally applicable standard is applied. As discussed in more detail below, state law varies based on several considerations, including: (1) whether liquidated damages provisions are presumptively enforceable or unenforceable;\(^9\) (2) whether the reasonableness of the estimate of damages is judged based on reasonableness at the time of contracting or at the time the provision is to be enforced;\(^10\) (3) the role actual damages play...
in determining the reasonableness of the estimate; and (4) what factors courts will consider in deciding whether or not the provision constitutes an unenforceable penalty.

Because of these differences, a provision that is enforceable under one state’s law could be unenforceable under another state’s law, even when the standard of review is essentially the same. Moreover, although the determination of whether the provision is reasonable is generally a question of law, the facts—the amount of actual damages arising from the breach, whether or not the franchisor mitigated its damages, the reason for the breach, etc.—can play a significant role in a court’s determination of whether to enforce a liquidated damages provision. Indeed, courts purporting to apply the same law have reached opposite results when construing an identical liquidated damages provision. At the same time, in construing liquidated damages provisions, a court will always start by examining the language of the provision. Thus, our analysis begins with a discussion of

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13. Compare Howard Johnson Int’l Inc. v. HBS Family, Inc., No. 96 CIV. 7687 (SS), 1998 WL 411334, at *8 (S.D.N.Y. July 22, 1998) (holding that liquidated damages provision that required payment of a minimum of $2,000 per each guest room was unenforceable under New York law) with Howard Johnson Int’l, Inc. v. SSR, Inc., No. CV 14-4611, 2017 WL 1246348, at *4 (D.N.J. Apr. 3, 2017) (holding that liquidated damages provision that required payment of a minimum of $2,000 for each room was enforceable under New Jersey law).

14. See e.g., SSR, Inc., 2017 WL 1246348, at *4 (“[W]hether a liquidated damages clause is enforceable is a question of law for the court to decide.”); but see Honey Dew Assocs., Inc. v. M & K Food Corp., 241 F.3d 23, 28 (1st Cir. 2001) (“Determining the validity of a liquidated damages clause is usually a fact-specific exercise.”).

15. See infra, Section IV.

16. Compare Shree Ganesh, Inc. v. Days Inns Worldwide, Inc., 192 F. Supp. 2d 774, 786–87 (N.D. Ohio 2002) (applying New Jersey law but holding liquidated damages provision in Days Inn franchise agreement was unenforceable because “the amount of damages as calculated based on the number of rooms is approximately five times the amount that would have resulted if the calculation were based on Recurring Fees”) with Days Inns of Am., Inc. v. P & N Enters., Inc., 164 F. Supp. 2d 255, 261–63 (D. Conn. 2001) (applying New Jersey law and holding that identical provision was enforceable as a reasonable estimate of potential damages).
issues to be considered when drafting liquidated damages provisions for franchise agreements.

III. Drafting Considerations for Liquidated Damages Provisions

There are a number of issues to consider when drafting a liquidated damages provision in a franchise agreement, several of which are examined in this section.

A. The Breach Being Addressed

First, the drafter must consider the breach sought to be addressed. The most commonly litigated liquidated damages provisions in the franchise context provide for liquidated damages to be paid when the franchisor terminates the franchise agreement as the result of the franchisee’s breach or default.

However, franchisors also often include other types of liquidated damages provisions in their agreements. Many franchise agreements provide that the franchisee must pay interest or a specified late fee for royalties, marketing fees, or other contractually required payments that are not paid when due. Franchisors might also include provisions that charge a fixed amount for a specific breach, such as for violation of post-termination obligations to de-identify a location or noncompliance with a post-termination non-compete or non-solicitation covenant. Another example arises from a prohibition against a franchisee offering the franchisor’s branded products from any location other than the location for the franchised business specified in the franchise agreement. Because the damages from such unauthorized sales are difficult to determine at the time of contracting, franchisors might include a provision that obligates a franchisee to pay an increased royalty percentage (say ten percent instead of five percent) on those sales. Courts will often carefully scrutinize whether damages flowing from the specific breach will be difficult to ascertain or whether the provision merely imposes an additional monetary obligation in an attempt to compel compliance; if the latter, the provision is more likely to be deemed a penalty.

17. See, e.g., Doctor’s Assocs., Inc. v. Vinnie’s Smokehouse/Meat Specialty, LLC, No. CIV.A. 10-3661, 2011 WL 2748668, at *2 (E.D. La. July 13, 2011) (holding that provision in franchise agreement requiring payment of $230 per day for failure to cease using franchisor’s copyrighted materials after termination was a reasonable measure of the franchisor’s daily loss); Ace Hardware Corp. v. Marn, Inc., No. 06-CV-5335, 2008 WL 4286975, at *11–15 (N.D. Ill. Sept. 16, 2008) (holding that provision imposing a “$10,000.00 fee per month for non-compliance with signage removal post-termination” was an enforceable liquidated damages provision).

18. See, e.g., Lelli’s Inn, Inc. v. Steven Lelli’s Inn on the Green, L.L.C., No. 13-14766, 2017 WL 6521325, at *14 (E.D. Mich. Oct. 24, 2017), report and recommendation adopted, No. 13-14766, 2017 WL 6513009 (E.D. Mich. Dec. 20, 2017) (enforcing liquidated damages provision requiring payment of $10,000 for each instance of noncompliance with post-termination obligation to de-identify as to some violations but not others because “the treatment of a failure to meet the conceal deadlines as having the same value as a failure to meet the modify/remove deadlines operates as a penalty because a breach of the conceal deadline is plainly less severe”).
B. Reasonable Estimate of Damages

The next consideration—and perhaps the most important—is whether the formula used to calculate the damages is a reasonable estimate of the potential damages that will result from the breach. This question is tied to the type of provision being evaluated.

1. Provisions Relating to Termination

In the case of termination arising from a franchisee breach, the damage to the franchisor is the loss of an open and operating business generating both goodwill for the brand and revenue (via royalties) for the franchisor. Without a liquidated damages provision, a franchisor would likely seek to recover lost future royalties as a measure of damages. Thus, a reasonable estimate of the damage to the franchisor from a premature termination might be the lost royalty stream. As a result, franchisors will often include a provision that calculates liquidated damages as royalties that the franchisee would have paid for some period after termination, based on a franchisee’s operating results prior to termination. For example, liquidated damages could be calculated by (1) determining the franchisee’s average monthly sales, based on the franchisee’s monthly sales for the prior 24 months;\(^{19}\) (2) multiplying the average monthly sales figure times the royalty percentage due under the franchise agreement;\(^{20}\) and (3) multiplying that monthly royalty figure times some number of months for which the franchisor seeks future royalties as damages.\(^{21}\)

19. Instead of determining the average periodic sales, some provisions use the sales from the period during some historical time frame that were the greatest during that time frame. For example, over a twenty-four month period, the sales in the month in which the franchisee’s sales were the largest would be used to calculate the liquidated damages. See, e.g., Creative Am. Educ., LLC, 2015 WL 4655087, at *51, aff’d sub nom. Creative Am. Educ., LLC v. Learning Experience Sys., LLC, 668 F. App’x 883 (11th Cir. 2016) (enforcing provision that relied on “the single highest monthly Gross Revenues from the previous thirty-six (36) month period before the termination” to calculate liquidated damages); DAR & Assocs., Inc. v. Uniforce Servs., Inc., 37 F. Supp. 2d 192, 202 (E.D.N.Y. 1999) (“[P]laintiffs’ assertion that the use of the highest monthly service charge in the year preceding termination turns the damage formula into a penalty has no merit.”).

20. Some provisions base the calculation on the average periodic royalties the franchisee paid over some time period prior to termination as opposed to calculating the liquidated damages by determining the average periodic sales over some time period prior to termination and multiplying that amount times the contractual royalty percentage. However, the former provision might understate the actual damage to the franchisor in lost future royalties, to the extent that the franchisor reduced the royalty percentage for some limited period prior to termination as a development, remodel or other incentive, or as an accommodation to a struggling franchisee, or the franchisee was underpaying royalties. On the other hand, the franchisee might argue that a provision that is not based on the actual royalties it paid is unreasonable.

21. A franchisor also might consider including in the formula the amount paid for marketing fund fees. See Shoney’s N. Am., LLC v. Smith & Thaxton, Inc., No. 3:12-CV-00625, 2014 WL 7369987, at *14 (M.D. Tenn. Dec. 29, 2014) (rejecting franchisee argument that marketing funds fees were improperly included in the calculation of liquidated damages based on terms of franchise agreement). In addition, a franchisor could include a separate formula to account for lost profits from payments made to the franchisor (or an affiliate) for purchases of branded products from the franchisor (or its affiliate). For that formula, the franchisor would need to calculate the average profit it received from those purchases over some historical period and use a
In drafting such a provision, the franchisor should carefully consider each element of the formula. First, how many years of historical operating results will be considered? From the example above, if the look-back is too long, the average monthly sales figure derived might be not be an accurate indicator of the current performance of the franchised business and, therefore, would not be a reasonable estimate of actual damages. If the look-back is too short, it may capture disappointing operational results that led to the default and termination, which would not accurately reflect the business’s actual operating capacity prior to the issue that resulted in the termination. Ideally, the franchisor should select a time period for determining the average sales that is based upon demonstrably reasonable considerations. One option is selecting a time period that courts have enforced under similar circumstances. Perhaps a better alternative is selecting a time frame the franchisor has used in evaluating the value of similarly situated businesses for purposes of purchasing a franchised business from a franchisee under a right of first refusal or otherwise, or for purposes of selling a corporate location to a franchisee.

Second, what multiplier (i.e., number of weeks, months, years) should the franchisor use in the formula? As discussed in more detail below, some courts have accepted a specified multiplier as reasonable in the context of liquidated damages provisions covering certain types of franchised businesses. Other courts have enforced provisions in which the time period was the remaining term of the agreement, no matter how much time remained. However, similar to selecting the time period of historical sales to calculate an average, the better course may be to tie the multiplier to a sound business rationale. For example, the franchisor could collect system data on the average amount of time it takes for the franchisor to develop a replacement franchised business in the applicable territory or market. This analysis would
include the time period to identify a qualified prospect and complete a sale, the time frame to build out a location and train and hire employees,\textsuperscript{25} and the time period after opening a new location for that location to reach a level of sales that is on par with other franchised locations in the same market or similar markets. This analysis also might segregate this information between new markets for the franchised system and markets in which the franchisor already has a presence, either with franchised or corporate locations.\textsuperscript{26} Because the average time period to develop a new franchised location is based on actual business realities, using that time period as the multiplier is more likely to result in a reasonable estimate of actual damages.\textsuperscript{27} Of course, that time period might change over time, so a franchisor should also consider undertaking this analysis periodically and revising its liquidated damages provision to account for such changes (while maintaining past analyses to ensure there is evidentiary support for older versions to the extent they are challenged).\textsuperscript{28}

2. Provisions Relating to Other Specific Breaches

In contrast to provisions addressing damages arising out of premature termination, it may be more difficult to determine a reasoned basis for liquidated damage designed to compensate for other specific breaches. For provisions that charge interest on late payments, the rationale is fairly straightforward (and consistent with similar provisions in other commercial and consumer contracts, leases, mortgages, etc.): in addition to not receiving

\textsuperscript{25} In determining this time period, the franchisor should also consider any deadline the franchise agreement places on completing construction and/or opening the location. If the average calculated and used in the liquidated damages provision is longer than the period that the franchise agreement actually affords a franchise to complete construction and open the location after execution, the liquidated damages provision might be deemed unreasonable. Alternatively, rather than calculating the average time period it takes to get a location open after the prospect purchases the franchise and the franchise agreement is entered, the franchisor could simply use the time period that the franchise agreement affords the franchisee to open the location after execution. However, to the extent the franchisor routinely extends that time period, the multiplier will understate the potential actual damage to the franchisor. The better course, obviously, would be to ensure that the time period to open afforded in the franchise agreement is consistent with the reality of how long on average it takes to open a franchised location.

\textsuperscript{26} The franchisor might also determine the average cost of developing a new location (both in existing and new markets) and add that amount in as an additional element of the liquidated damages calculation. However, to the extent that cost is offset by the payment of an initial franchise fee (particularly where those fees are recognized for accounting purposes as payment to compensate for the costs incurred by the franchisor in developing a new franchised business), the franchisor does not really realize those costs as damages. It might therefore be unreasonable for the franchisor to include the cost of developing a new franchised business as liquidated damages.


\textsuperscript{28} Some provisions may also include a formula to discount the amount of lost future royalties calculated to a present value. See, e.g., Century 21 Real Estate, LLC v. Ramron Enters., No. 1:14-CV-00788-AWI, 2015 WL 521350, at *8 (E.D. Cal. Feb. 9, 2015) (“The present value of the total calculated [pursuant to formula] at a discount rate of 8%, assuming payment is made at the end of each month, will constitute our liquidated damages.”).
the actual payment (which can be calculated at the time of breach without any difficulty), the franchisor has been damaged by the lost investment value of that money. In light of state laws mandating maximum amounts that can be charged as interest on late payments under commercial lending agreements, provisions in franchise agreements obligating the franchisee to pay interest on late payments are commonplace and routinely enforced without challenge.

Other provisions that seek to charge the franchisee a fee in connection with a specified breach require a bit more analysis:

- Late fees, charged in addition to or in lieu of interest, can often be justified based on the fact that is difficult to determine with reasonable certainty the internal cost to a franchisor from a franchisee’s failure to timely pay fees. Employee time spent contacting the franchisee, preparing statements of account, and negotiating payment schedules could arguably be spent on other business matters. Because these nuisance costs cannot easily be determined, a small late fee can often be justified as reasonable. However, if the late fee is not proportional to the amount unpaid, it may instead be deemed a penalty. So, for example, if the late fee is $500 but the average weekly royalty payments are $2,500, the late fee—20% of the average royalty payment—might be deemed a penalty.29

- Provisions for the payment of a higher royalty percentage on unauthorized sales (outside of an assigned territory or from an unapproved location) may be more difficult to justify. Arguably, if the franchisee pays standard royalties on those sales, the franchisor is not really damaged. And if the franchisee does not pay royalties on those sales, the franchisor’s damages would be the lost royalties. On the other hand, if the franchisee is selling outside of its assigned territory or from another location, a second franchised location is potentially viable (or the franchisee is taking sales away from another franchised location). In that case, the franchisor’s damages also include the fact that the unauthorized sales are inhibiting growth of the system and preventing the franchisor from capturing that growth through the establishment of new franchised business (along with any initial franchise fees the franchisor would receive). Because those damages are not easily quantified, assessing a higher royalty percentage on such sales may be reasonable.

29. See, e.g., Mattvidi Assocs. Ltd. P’ship v. NationsBank of Virginia, N.A., 639 A.2d 228, 238 (Md. Ct. App. 1994) (collecting cases from multiple jurisdictions and noting that “[t]he modern view seems to be that [late charge provisions] are not penalties but reasonable compensation in commercial transactions, because of the difficulty and impracticality of fixing the amount of actual damages for administrative expenses that will be sustained in the event of late payments”) (internal quotation marks omitted).
A franchisor might charge a set amount as liquidated damages arising out of a franchisee’s failure to de-identify after termination. In at least one case, such a provision has been deemed enforceable.\(^{30}\)

Franchisors might also provide for the franchisee to pay costs associated with the franchisor addressing a particular breach. For example, a franchisor might wish to charge a franchisee for the cost of conducting a follow-up inspection after the franchisee fails an inspection, the cost of a financial audit after a franchisee fails to report sales for some period of time, or the cost of providing training to employees when the franchisee fails to maintain the required number of trained staff. However, in these circumstances, the franchisor’s damages—the costs incurred as a result of the particular breach—can be readily ascertained at the time they are incurred. As result, the better course in these circumstances is to obligate the franchisee to reimburse the franchisor for the actual costs rather than specifying a liquidated amount that may not accurately reflect the actual damage to the franchisor.

### 3. Provisions Particular to Certain Industries—Specific Amount per Room for Hotel Franchise Agreements

In franchise agreements for hotels and motels, liquidated damages are commonly calculated based upon the number of rooms in the franchised hotel or motel. The question in those situations is whether the dollar figure per room is a reasonable estimate of the actual damages at the time of contracting, i.e., the estimated revenue a hotel room will generate for the franchisor over a period of time. Not surprisingly, courts have both enforced\(^ {31}\) and failed to enforce\(^ {32}\) such provisions, based upon the facts presented.

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31. See, e.g., HBS Family, Inc., 1998 WL 411334, at *7 (Sotomayor, J.) (finding that liquidated damages calculation based on royalty revenues for twenty-four months after termination reasonable, but finding that “the alternative method . . . for calculating liquidated damages . . . that ‘in no event shall be less than the product of $2,000.00 multiplied by the number of guest rooms in the Facility’ was ‘not a reasonable estimate of the potential loss likely to be suffered because it does not take into account the length of time remaining on the unexpired License Agreement at the time of default’ and was therefore not proportional to the possible loss)."
32. See, e.g., Howard Johnson Int’l, Inc. v. SSR, Inc., No. CV 14-4611, 2017 WL 1246348, at *4 (D.N.J. Apr. 3, 2017) (holding liquidated damages provision that require payment of $2,000 per room enforceable “[b]ecause it is difficult to estimate these damages due to the transient lodging business” and because “the liquidated damages clause represents a good faith estimate of the monetary damages that [the franchisor] sustains when a franchisee causes the premature termination of a franchise agreement”); Knights Franchise Sys., Inc. v. P.C.P.S. Corp., No. CIV. 06-5243, 2009 WL 3526229, at *5 (D.N.J. Oct. 21, 2009), aff’d, 420 F. App’x 155 (3d Cir. 2011) (“[T]he Court is satisfied that the liquidated damages provision, which assesses damages as $500 per guest room authorized to operate at the time of the termination . . . provides a reasonable forecast of future lost recurring fees that would otherwise be nearly impossible to predict.”); Howard Johnson Int’l, Inc. v. Goodland Inns, Inc., No. CIV. A. 06-5137 (JAG), 2008 WL 2229826, at *4 (D.N.J. May 28, 2008) (enforcing liquidated damages provision of “no less than the product of $2,000.00 multiplied by the number of guest rooms in the Facility” on motion for default judgment).
This method for providing for liquidated damages may also be applicable to franchise business models outside of the lodging industry. Arguably, a franchisor could estimate damages based on a dollar amount per customer for concepts that provide repeat services to specific customers, such as home cleaning and maintenance services, tax preparation business, rent-to-own businesses, tutoring and educational service businesses, and other businesses where one asset of the business is customer accounts. Premature termination of the franchise agreement would result in an unmeasurable loss of customer accounts that could be estimated via a set amount for each customer of the business. However, unlike the hotel/motel model, where the number of rooms is certain both at the time of contracting and at the time of breach, the number of customer accounts may not be as easily ascertainable. In any event, the franchisor would still need to establish that the amount per customer stated in the contract is a reasonable estimate of the amount of revenue or profit each customer of the franchisee would have generated for the franchisor.

C. The Issue of Intent

One final consideration in drafting a liquidated damages provision is whether the franchisor intends the provision to be a penalty or not. In some jurisdictions, the parties’ intentions are irrelevant to the evaluation of a liquidated damages provision. However, a number of other jurisdictions require that the parties intend to provide for liquidated damages. Absent that intent, whether demonstrated by the circumstances, the language of the entire agreement, or the use of the term “liquidated damages” (which courts do not often find to be dispositive), courts in those jurisdictions

33. See e.g., Leisure Sys., Inc. v. Roundup, LLC, No. 1:11-CV-384, 2012 WL 5378302, at *14 (S.D. Ohio Oct. 31, 2012) (“In determining whether a stipulated damages clause is enforceable, neither the parties’ actual intention as to its validity nor their characterization of the term as one for liquidated damages or a penalty is significant in determining whether the term is valid.”) (internal quotation marks omitted) (quoting In re Graham Square, Inc., 126 F.3d 823, 829 (6th Cir. 1997)).

34. See e.g., Rainbow Country Rentals & Retail, Inc. v. Ameritech Publ’g, Inc., 2005 WI 153, 706 N.W.2d 95, 103 (Wis. 2005) (explaining the test to determine reasonableness of liquidated damages clause includes whether the parties intended to provide for damages or for a penalty); Guiliano v. Cleo, Inc., 995 S.W.2d 88, 100 (Tenn. 1999) (addressing the recovery of liquidated damages and noting that Tennessee courts focus on the intentions of the parties based on the language in the contract and the circumstances that existed at the time the contract was formed); Ramada Franchise Sys., Inc. v. Motor Inn Inv. Corp., 755 F. Supp. 1570, 1578 (S.D. Ga. 1991) (Georgia law) (“Although the specific words ‘liquidated damages’ are not required for a court to find the provision enforceable, there must be some clear manifestation of the parties’ intent to agree to liquidated damages.”).

35. See e.g., Airport Square Holdings, LLC v. GCCFC 2007-GG9 Colomary Facilities, LLC, No. CV JFM-16-02883, 2017 WL 639230, at *8 n.12 (D. Md. Feb. 16, 2017) (“[T]he language expressly denying that the liquidated damages clause is a penalty is highly probative of the parties’ intentions when entering into the contract.”); In re Galleria Investments LLC, No. A06-62557-PWB, 2008 WL 7842107, at *14 (Bankr. N.D. Ga. Apr. 4, 2008) (“[T]he use of the term ‘liquidated damages’ is not necessarily dispositive.”); Guiliano, 995 S.W.2d at 97 (“A contractual provision need not explicitly include the term ‘liquidated damages’ to constitute a liquidated
may deem the provision a penalty rather than an enforceable liquidated damages provision.36

IV. Enforcement of Liquidated Damages Provisions

The enforceability of a liquidated damages provision will often turn on how the provision is drafted. However, there are a number of additional considerations to assess, many of which are discussed in this section.

A. Procedural Issues

1. Is Reasonableness of the Provision a Question of Law or an Issue of Fact?

In most jurisdictions, the enforceability of a liquidated damages provision is deemed to be a question of law for a court to decide.37 As a result, this issue can often be resolved on a motion for summary judgment.38 Indeed, courts will often evaluate a provision based on whether similar provisions have been deemed to be enforceable, without addressing the particular facts or circumstances of the case before the court.39 However, many courts have noted that the questions of whether the provision is a reasonable esti-
mate of potential damages and whether damages would be difficult to calculate require an examination of facts.\textsuperscript{40} Parties seeking to enforce or invalidate a liquidated damages provision should therefore present both legal authority and evidence to support their arguments.\textsuperscript{41} Otherwise, a court may decide that, although enforceability is a legal question for the court to decide, there is a lack of evidence to support a finding of whether the provision should or should not be enforceable.\textsuperscript{42} And, while the ultimate question may be one for resolution by the court, the enforceability of a liquidated damages provision will not often be resolved on a motion to dismiss.\textsuperscript{43}

2. Does the Governing State Law Deem Liquidated Damages Provisions Presumptively Valid?

Historically, liquidated damages provisions were strictly scrutinized in many jurisdictions because of the assumption they were simply a means of compelling performance under a contract, i.e., a penalty.\textsuperscript{44} For example, prior to 1977, California Civil Code Sections 1670 and 1671 provided that

\begin{itemize}
  \item \textsuperscript{40} See e.g., Honey Dew Assocs., Inc. v. M & K Food Corp., 241 F.3d 23, 28 (1st Cir. 2001) ("Determining the validity of a liquidated damages clause is usually a fact-specific exercise."); UPS Store, Inc. v. Hagan, No. 14CV1210, 2016 WL 1659188, at *3 (S.D.N.Y. Mar. 15, 2016) ("It was the [franchisees'] burden to set forth specific facts showing that there is a genuine issue as to the enforceability of the liquidated-damages clause . . . [a]nd after prompting from this Court, they do not offer evidence on which this Court can invalidate the clause."); Caudill v. Keller Williams Realty, Inc., No. 13 C 4693, 2013 WL 5874761, at *4 (N.D. Ill. Oct. 31, 2013) ("Before this Court answers the legal question [defendant] posits of whether this liquidated damages provision is a penalty, factual issues must be resolved. To determine the reasonableness of the liquidated damages provision would require this Court to make certain determinations—like the circumstances that existed when the parties executed the Settlement Agreement—that it is presently unprepared to make."); Rescuecom Corp. v. Chumley, No. 5:07-CV-0690, 2011 WL 1204758, at *10 (N.D.N.Y. Mar. 28, 2011) ("It is well established that whether a clause represents an enforceable liquidation of damages or an unenforceable penalty is a question of law, giving due consideration to the nature of the contract and the circumstances.").
  \item \textsuperscript{41} See Section IV, infra.
  \item \textsuperscript{42} See, e.g., Shoney's N. Am., LLC, 2014 WL 7369987, at *15 (granting summary judgment for franchisor because "[t]he defendants . . . do not refute any part of [the franchisor's] declaration or . . . assertions regarding the damages owed, and they have presented no evidence to suggest that the liquidated-damages clause . . . functions as a penalty or unenforceable forfeiture"); Captain D's, 2010 WL 5060289, at *8 (enforcing liquidated damages provision because "[w]hile Defendants have asserted that the liquidated damages provisions function as penalties, they have not offered any support for that contention"); Days Inn of Am., Inc. v. Patel, 88 F. Supp. 2d 928, 936 (C.D. Ill. 2000) (holding that because franchisee had "failed to offer any proof, other than mere argument by counsel, as a basis for setting aside the liquidated damages provision. . . . , the liquidated damages clause . . . is reasonable, valid, and enforceable"); HBS Family, Inc., 1998 WL 411334, at *8 (refusing to enforce liquidated damages provision because "there is nothing to show that the sum of $2,000 per each guest room in the 112-room facility bears any reasonable relationship to the pecuniary harm plaintiff would have likely suffered in the event of a breach").
  \item \textsuperscript{43} See, e.g., Caudill, 2013 WL 5874761, at *4 ("The issue of reasonableness of [the liquidated damages provision] pertains more to the merits, and a Rule 12(b)(6) motion tests the sufficiency of the complaint, not the merits of the case."); Blasko v. Petland, Inc., No. 2:08-CV-01105, 2010 WL 11537972, at *4 (S.D. Ohio Mar. 9, 2010) (denying motion to dismiss claim for liquidated damages and affording the parties “the opportunity to engage in discovery, and evidence outside the pleadings and the agreement” to “demonstrate at the summary judgment phase, or at trial, that the agreed damages provision is an unenforceable penalty”).
  \item \textsuperscript{44} See LaFiura & Sager, supra note 2, at 175.
\end{itemize}
“Every contract by which the amount of damage to be paid, or other compensation to be made, for a breach of an obligation, is determined in anticipation thereof, is to that extent void” except to the extent “[t]he parties to a contract . . . agree . . . upon an amount which shall be presumed to be the amount of damage sustained by a breach thereof, when, from the nature of the case, it would be impracticable or extremely difficult to fix the actual damage.”

This statutory framework placed the burden on the party seeking to enforce the liquidated damages provision to present evidence to prove the exception to the general rule. However, in 1977, these sections of the Civil Code were amended to provide that “a provision in a contract liquidating the damages for the breach of the contract is valid unless the party seeking to invalidate the provision establishes that the provision was unreasonable under the circumstances existing at the time the contract was made.” Under this new standard, California courts are required to deem liquidated damages provisions to be presumptively valid.

Several other jurisdictions also presume the validity of liquidated damages provisions. In those jurisdictions, that presumption can only be overcome with proof the provision is actually a penalty or the amount of liquidated damages is either an unreasonable estimate of possible damages or bears no reasonable relationship to actual damages. For example, in Montana, that presumption may only be overcome with a showing that the provision is unconscionable. In contrast, as noted earlier, Utah courts review liquidated damages provisions: Strategic Drafting and Enforcement Issues

46. See Better Food Markets v. Am. Dist. Tel. Co., 253 P.2d 10, 14 (Cal. 1953) (“Unless a clause providing for liquidated damages falls within the provisions of section 1671 it is invalid, . . . and except on admitted facts this is generally a question to be resolved by the trier of fact. . . . It is settled law that the burden is on the party seeking to rely upon a liquidated damage provision in a contract to plead and prove facts showing impracticability.”) (Citations omitted.)
47. CAL. CIV. CODE § 1671(b).
48. Majestic Towers, Inc., 488 F. Supp. 2d at 958–59 (“The modern form of California’s liquidated damages statute has switched the presumption from invalidity to validity. . . . [A] provision in a contract liquidating the damages for the breach of the contract is valid unless the party seeking to invalidate the provision establishes that the provision was unreasonable under the circumstances existing at the time the contract was made.”) (internal quotation marks omitted) (quoting CAL. CIV. CODE § 1671(b)).
50. See Section IV.B, infra.
51. Highway Specialties, Inc. v. State, Dep’t of Transp., 215 P.3d 667, 670 (Mont. 2009) (“[I]liquidated damages provisions are presumed enforceable and will be enforced unless the party opposing the provision has established that it is unconscionable.”).
dated damages provisions in the same manner as other contract terms and will invalidate those provisions only on grounds on which contract provisions are generally deemed unenforceable (mistake, fraud, duress, unconscionability, etc.).52 In these jurisdictions, enforcement may be more likely due to the presumption of validity.

3. Who Bears the Burden of Proving Enforceability of the Provision?

Another procedural consideration is the determination of which party bears the burden of proving that the liquidated damages provision is: (1) enforceable or unenforceable; (2) reasonable or unreasonable; or (3) valid or a penalty. In those states where such provisions are presumed to be valid, the burden obviously falls on the party seeking to overcome the presumption.53 Indeed, the majority of other states also place the burden on the party seeking to avoid enforcement of the liquidated damages provision.54 In fact, very few states place the burden of proof of reasonableness or enforceability on the party seeking to enforce a liquidated damages provision.55 At the same time, even though a franchisor may not have the burden of proof, in most cases (discussed more fully below) the franchisor is better served to present evidence to support a finding of enforceability, particularly to avoid a disputed issue of material fact when moving for summary judgment.

52. Commercial Real Estate Inv., L.C. v. Comcast of Utah II, Inc., 285 P.3d 1193 (Utah 2012) (holding that liquidated damages clauses should be evaluated in the same manner as other contractual provisions and not subject to heightened judicial scrutiny).
53. See, e.g., Wingate Inns Int’l, Inc., 2012 WL 3550764, at *6 (“New Jersey law . . . provides that liquidated damages provisions in a commercial contract between sophisticated parties are presumptively reasonable, and the party challenging the clause bears the burden of proving its unreasonableness.”); O’Brien v. Langley Sch., 507 S.E.2d 363 (Va. 1998) (explaining that the party challenging the validity of liquidated damages clause bears the burden of proof on that issue); Kim Shin Hosp. Inc., 27 F. Supp. 2d at 1383 (explaining that under California law, a liquidated damages clause is presumed valid and the burden is on the party seeking invalidation to establish that the provision is unreasonable).
54. See 24 WILLISTON ON CONTRACTS § 65:30 (4th Ed.) (“The more widely held view appears to be that the burden is on the party seeking to invalidate a stipulated damages provision to prove that it constitutes an unenforceable penalty.”); Honey Dew Assocs., Inc. v. M & K Food Corp., 241 F.3d 23, 27 (1st Cir. 2001) (applying Massachusetts law, and finding that “the prevailing rule is that the party challenging the enforceability of a liquidated damages clause has the burden of proving that it is a penalty”); O’Brien, 507 S.E.2d at 366 (collecting cases).
55. See Hendricks Prop. Mgmt. Corp. v. Birchwood Props. Ltd. P’ship, 741 N.W.2d 461, 467 (N.D. 2007) (“A party seeking to enforce a contractual clause for liquidated damages has the burden of proof under N.D.C.C. § 9–08–04.”); Robins Motor Transp., Inc. v. Associated Rigging & Hauling Corp., 944 F. Supp. 409, 412 n.2 (E.D. Pa. 1996) (“[T]he party seeking to enforce a liquidated damages clause has the burden of demonstrating its reasonableness.”); AT & T Info. Sys., Inc. v. Smith, 593 So. 2d 673, 676 (La. Ct. App. 1991) (“Plaintiff is seeking the award of liquidated damages and has the burden of proving reasonableness.”); Pacheco v. Scobionko, 532 A.2d 1036, 1039 (Me. 1987) (“We adopt the rule that the party seeking enforcement of a liquidated damages clause in a contract has the burden of proving its validity . . .”); Waggoner v. Johnston, 408 P.2d 761, 768 (Okla. 1965) (“[T]he burden of establishing that the damages were difficult of ascertainment rests on the party seeking the enforcement of the liquidated damage clause, and the fact that the parties have expressly stated in the contract that the damages are difficult to determine does not shift the burden of proof on this issue.”).
B. What Evidence Should Be Presented to Prove That a Liquidated Damages Provision Is or Is Not Enforceable?

As discussed earlier, the enforceability of liquidated damages provisions is often a question of law, and the law presumes that such provisions are valid. And in some cases, courts will ignore the facts of a particular case when a specific liquidated damages provision has been held enforceable or unenforceable in a prior case. However, more often than not, when dealing with liquidated damages provisions in franchise agreements, whether or not the provision is enforceable usually turns on the circumstances and factual evidence presented by the parties.

Under the general standard recited earlier, the provision will be enforced if the amount of liquidated damages is a reasonable estimate of the presumed actual damages that a breach would cause and the amount of actual damages that would result from a breach were difficult to ascertain; in some states, the parties must also be found to intended to liquidate damages, as opposed to impose a penalty for nonperformance. The party seeking to recover liquidated damages is obligated, at a minimum, to provide evidence sufficient for a court to calculate the amount of the liquidated damages. Regardless of who bears the burden of proof, the questions remain: how do you prove (1) whether actual damages would be difficult to determine; (2) what a reasonable estimate of actual damages would be; and (3) what the parties intended?

1. Proving that Actual Damages Would Be Difficult to Ascertain

In the context of franchise cases—and depending on the type of liquidated damages provision at issue—the issue of whether actual damages will be difficult to ascertain is usually decided in favor of enforcement of the liquidated damages provision. As discussed earlier, the most common liquidated damages provision in a franchise agreement is a provision that calculates damages arising from a termination of the franchise agreement. At the time the parties enter the agreement, the damages to a franchisor from termination are almost impossible to ascertain, given that the franchised business has yet to generate any revenues or contribute to the goodwill of the brand.\textsuperscript{56} Even when considered at the time of termination, the damages to the franchisor are likely still difficult to calculate.

A franchisee could argue\textsuperscript{57} that the actual damages—the amount of lost royalties for some period of time after termination—can be calculated and

\textsuperscript{56} See Kim Shin Hosp., Inc., 27 F. Supp. 2d at 1383 (“The resulting harm from the premature termination would be lost future profits. Factors that can affect future profitability include the future business ability of the franchisee, changes in the formation of highways and occurrence of traffic, gas and oil shortages, and the general ability of the public at large to use the facilities. . . . Thus, it would be very difficult to estimate future profits at the time of the contract.”) (internal citations and quotations omitted)

\textsuperscript{57} Of course, a franchisee might want to avoid this argument if a lost future royalty calculation might actual result in a damages calculation that exceeds the amount of liquidated dam-
actually are calculated in many cases where liquidated damages provisions are not included in the contract. In limited cases—particularly when the court also determines that the actual damages would likely be much less than the calculated liquidated damages—courts have agreed with this argument. However, more often, courts have concluded that actual damages to a franchisor arising from a premature termination are not readily ascertainable. Factors such as (1) an inability to determine how much revenue the franchised business would have continued to generate for the balance of the term of the agreement and (2) the difficulty in calculating the value of the goodwill lost from the closure of a franchised business in a market have been deemed material to a determination that the actual damages are too speculative to calculate with any certainty. Again, although the franchisor may not bear the burden of proving the liquidated damages provision is enforceable, a franchisor is well-served by presenting these arguments and ages. Moreover, by making this argument, a franchisee would be hard pressed to argue that a lost future royalty calculation is too speculative.

58. See, e.g., Days Inns of Am., Inc. v. P & N Enters., Inc., 164 F. Supp. 2d 255, 262 (D. Conn. 2001) (franchisee argued that liquidated damages provision was unenforceable because actual damages could be calculated based on franchisor’s knowledge of “1) the room rates that [franchisee] planned to charge, 2) the occupancy rates of the Facility from the time period when it had previously been operated as a Days Inns franchise, 3) the average occupancy rates for Days Inns’ other franchisees, 4) the percent of gross room revenue due Days Inns under the License Agreement, and 5) the average time period to replace a franchisee”).

59. See, e.g., Coleman Co. v. Hlebanja, No. 96 CIV. 1288 (MBM), 1997 WL 13189, at *5 (S.D.N.Y. Jan. 15, 1997) (holding that liquidated damages provision related to breach of post-sale noncompetition covenant was unenforceable because, among other things, it . . . would not seem difficult to determine actual damages from defendants’ improper sale of camping equipment” in violation of the noncompete).

60. See, e.g., P & N Enters., Inc., 164 F. Supp. 2d at 262 (“[T]he court concludes that actual harm was very difficult to accurately estimate, both at the time of contract formation and at the time of the breach. The court finds persuasive the plaintiff’s recitation of variables which would have made the prospective calculation of actual damages very difficult: whether P & N would comply with Days Inns’ quality assurance standards, whether room rates would increase if occupancy rates increased, whether competitors would enter the Meriden market, the state of the national and regional economies, and whether fuel prices would rise to the extent of curtailing travel.”); Cusack Dev., Inc., 1999 WL 165702, at *7 (finding actual damages from early termination were difficult to ascertain at time of contracting based on affidavit testimony that “there is no way to determine precisely what royalties Ramada would have received during the remainder of the Agreement’s term” because “future hotel revenue is a function of variable factors including the national, regional and local economies, travel patterns of vacationers, the entry or withdrawal of competitors from the market and the effort, skill and resources of the licensee”).

61. See, e.g., La Quinta Corp. v. Heartland Props. LLC, 603 F.3d 327, 340 (6th Cir. 2010) (“Actual damages, in the context of the hospitality industry, are difficult to quantify and not strictly monetary; a franchise operation yields not only future royalties, but additional intangibles such as brand recognition and loyalty, and a competitive presence in a geographic region.”); Creative Am. Educ., LLC, 2015 WL 4655087, at *50, aff’d sub nom. Creative Am. Educ., LLC v. Learning Experience Sys., LLC, 668 F. App’x 883 (11th Cir. 2016) (“The difficulty in estimating damages under the facts of this case warrants an application of liquidated damages. TLE was required to incur expenses related to seizing the centers, staffing the centers, and repairing the damage done to its brand. These expenses are difficult to quantify, particularly expenses related to the damage CAE’s actions caused to the TLE brand.”).
evidence to aid the court in concluding that the actual damages resulting from a premature termination are not easy to determine.62

2. Is the Calculated Amount a Reasonable Estimate of Damages?

Perhaps the most litigated issue in franchise cases involving liquidated damages is whether or not the amount specified in the franchise agreement is a reasonable estimate of the potential damages from the breach. The answer often will turn on two questions: (1) whether the court looks at the estimate prospectively or retrospectively; and (2) what weight the court gives to the actual damages sustained by the franchisor.

a) Prospective versus Retrospective Approaches

Under the prospective approach, the court will assess whether or not the liquidated damages provision provided a reasonable estimate of actual damages at the time the parties entered the contract.63 When the calculation is based on estimated lost royalties for some period of time after termination, courts have generally held that the calculation is a reasonable estimate of the potential damages,64 particularly when the time period used to calculate the damages is less than the time remaining on the term of the franchise agreement.65 To support enforcement, franchisors should submit evidence of the historical payments received from the franchised business to calculate what the expected payments might have been if the relationship had continued.66

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62. See, e.g., Days Inn of Am., Inc. v. Patel, 88 F. Supp. 2d 928, 935 (C.D. Ill. 2000) (“Based upon Miller’s affidavit, the Court finds that Days Inns’ actual damages are difficult to calculate.”).

63. See Guiliano v. Cleo, Inc., 995 S.W.2d 88, 98–99 (Tenn. 1999) (“One method, commonly referred to as the ‘prospective approach,’ focuses on the estimation of potential damages and the circumstances that existed at the time of contract formation.”) (collecting cases from jurisdictions applying this approach).

64. See La Quinta Corp., 603 F.3d at 340 (holding that formula based on historical fee accruals over a term of years was “based on common business practices and the parties’ recent historical performance under the License Agreement, resulting in ascertainable losses in the event of breach”); Country Inns & Suites By Carlson, Inc. v. Interstate Props., LLC, No. 6:07-CV-104-ORL-28DA, 2008 WL 2782683, at *4 (M.D. Fla. July 16, 2008), aff’d, 329 F. App’x 220 (11th Cir. 2009) (noting that “liquidated damages provisions with similar fee-based formulas have been upheld by numerous other courts in the hotel franchise context”); Cusack Dev., Inc., 1999 WL 165702, at *8 (“The reasoning of these cases is persuasive. The liquidated damages formula is intended to compensate Ramada for premature termination of the franchise. Past fees accrued to Ramada under the Agreement [are] a reasonable means by which to estimate future fees lost by Ramada during a period in which it has no replacement franchisee.”).

65. See, e.g., Patel, 88 F. Supp. 2d at 935 (“[B]ecause Patel breached the franchise agreement in its third year, Days Inns lost twelve years of revenue and recurring fees.”); Kim Shin Hosp., Inc., 27 F. Supp. 2d at 1383 (“The computation of damages based on five years worth of franchise payments is not unreasonable considering the License Agreement’s unexpired term of eighteen years.”). The failure to submit such evidence can be fatal—even on a motion for default judgment. See Knights Franchise Sys., Inc. v. Imperial Lodgings, LLC, No. 14-cv-6121, 2017 WL 1535090, at *4 (D.N.J. Apr. 26, 2017) (refusing to award liquidated damages where affidavit submitted by franchisor did not specify historical average monthly fee amount or multiplier used to calculated liquidated damages).

66. See, e.g., P.G.S., LLC, 2012 WL 3550764, at *7 (franchisor submitted evidence of recurring fees paid over an eight-month period ($160,000) to support claim for liquidated damages
Franchisors have also submitted evidence about the average amount of time it takes to replace a franchised business and recoup the lost goodwill from an early and unexpected termination. And in some instances, a franchisor will present evidence of what its actual lost royalty stream would be for the remaining term of the contract or evidence that it has been unable to replace the lost franchised business. All such evidence should be accurate and come from an executive who is competent to provide the information.

Franchisees will often argue that the historical royalties overstate the likely future royalties due to a decline in business that was a factor in the termination or that the franchisor can more quickly replace a lost unit than the amount of time used to calculate the liquidated damages. These arguments may be compelling in some circumstances. For example, if the historical royalty look-back is a long period of time and the franchisee’s revenues (and by extension royalty payments) declined significantly in more recent periods, the court might deem the average payment an inaccurate estimate of the likely payments going forward. Similarly, if the term remaining on the contract for fixed amount of $250,000 as reasonable estimate of loss of those fees for remaining term of the contract); Noons v. Holiday Hospitality Franchising, Inc., 705 S.E.2d 166, 169 (Ga. Ct. App. 2010) (finding that evidence franchisor submitted regarding past performance of franchise hotel was appropriate to calculate liquidated damages). Cf. 911 Restoration Franchise, Inc. v. Blakeney, No. CV 15-629-R, 2015 WL 12698290, at *3 (C.D. Cal. Sept. 22, 2015) (holding liquidated damages provision unenforceable as a penalty where franchisor failed to demonstrate “what the average value of the royalties paid during the last twelve months were; which of the two multipliers were used (twenty-four or the number of months remaining in the Agreement); or how such a formula even bears a reasonable relationship to the range of harm that [franchisor] might have reasonably anticipated”).

67. See, e.g., Radisson Hotels Int’l, Inc. v. Kaanam LLC, No. 09-CV-1575 PJS JJK, 2011 WL 98129, at *4 (D. Minn. Jan. 12, 2011) (citing assertions by franchisor in an affidavit that “it routinely takes upwards of two to four years or more for Radisson to recruit, identify, evaluate, approve, and train a qualified Radisson hotel franchisee to replace a terminated franchisee” and that “when one franchisee replaces another, it typically takes an additional period of time for that franchisee to reach the level of profitability achieved by the former franchisee”) (citations and internal quotation marks omitted); Cusack Dev., Inc., 1999 WL 165702, at *8 (citing affidavit testimony from franchisor that “a hotel franchise company requires two years on average to replace a lost franchisee in a given market”).

68. See, e.g., Downtowner/Passport Int’l Hotel Corp. v. Norlew, Inc., 841 F.2d 214 (8th Cir. 1988) (holding that that liquidated damages that did not exceed the actual damage amount are not a penalty, and are enforceable where the franchisee owed the franchisor $630 a month, and the liquidated damages clause required one half that amount for each month remaining in the franchise agreement).

69. Patel, 88 F. Supp. 2d at 935 (noting actual loss of future royalty revenue for balance of term and fact that “[s]ince Patel’s breach, Days Inns has been unable to operate or maintain a replacement facility in Lincoln, Illinois”).

70. See Majestic Towers, Inc., 488 F. Supp. at 960 (giving no weight to testimony of in-house attorney for franchisor about length of time needed to replace a terminated franchisee because her experience “does not qualify her to testify to Radisson’s experience in finding replacement franchisees”).

71. See infra notes 95–97.

72. But see Leisure Sys., Inc. v. Roundup, LLC, No. 1:11-CV-384, 2012 WL 5378302, at *16 (S.D. Ohio Oct. 31, 2012) (concluding that use of historical monthly fee payments to calculate liquidated damages was reasonable because that “royalties and service fees are averaged using the monthly averages for the three-year period immediately preceding termination, which accounts for possible peaks and valleys in the revenues of the franchisees due to seasonal demand or oth-
tract is less than the amount of time used to calculate the liquidated amount, the court might deem the calculation an overstatement of the likely actual damages. Likewise, a franchisee might argue that the estimate of future payments should be net of expenses or be discounted to a present value. However, in most cases, these types of arguments have been unsuccessful absent proof that the calculated damages are significantly greater than the actual damage to the franchisor (discussed more fully later).

In contrast, when the liquidated damages are based on a fixed amount, courts are more likely to conclude that the calculation is not a reasonable estimate of the actual damages. For example, some courts have determined that calculations based on the number of rooms in a hotel multiplied by a fixed amount are not a reasonable estimate of the actual damages to the franchisor arising out of a premature termination of a franchised hotel property. When faced with this type of provision, a franchisee would be well served to present evidence that the fixed amount is not a reasonable estimate of what the franchisee would have paid in royalties per room. On the other hand, when a franchisor can present evidence that the fixed amount is tied to the amount of revenue it could expect to receive on each room at a hotel over some period of time within the remaining term of a franchise agreement, courts have been willing to enforce these types of provisions.

Similarly, where the franchisee has not submitted any evidence to challenge otherwise, thereby minimizing the concern that the franchisees would be paying damages for months when they were earning little or no revenue.

73. Lager’s, LLC v. Palace Laundry, Inc., 543 S.E.2d 773, 778 (Ga. Ct. App. 2000) (holding that liquidated damages provision did not reasonably estimate potential damages because “the liquidated damages clause demanded payment for the remainder of the contract. There was no evidence, however, that Linens would not be able to find a replacement for Lager within the weeks remaining in the contract.”).

74. See Country Inns & Suites By Carlson, Inc. v. Interstate Props., LLC, No. 6:07-CV-104-ORL-28DA, 2008 WL 2782683, at *4–5 (M.D. Fla. July 16, 2008), aff’d, 329 F. App’x 220 (11th Cir. 2009) (rejecting franchisee’s arguments that applying a three-year multiple of royalty revenue would result in a windfall to the franchisor “because it is based upon gross income and not the profits. . . [and] because the liquidated damages amount is payable within ten days of the Agreement’s termination but is not reduced to its present value”); Holiday Hosp. Franchising, Inc. v. 174 W. Street Corp., Civ. Action No. 1:05-CV-1419-TWT, 2006 WL 2466819, at *8 (N.D. Ga. Aug. 22, 2006) (rejecting argument that liquidated damages provision was not a reasonable estimate because it did not account for expenses incurred by franchisor in calculating amount based on gross revenues).

75. See, e.g., HBS Family, Inc., 1998 WL 411334, at *7 (holding that provision that required minimum liquidated damages payment of $2,000 for every room in a hotel was “not a reasonable estimate of the potential loss likely to be suffered because it does not take into account the length of time remaining on the unexpired License Agreement at the time of default” and because “there is nothing to show that the sum of $2,000 per . . . guest room . . . bears any reasonable relationship to the pecuniary harm plaintiff would have likely suffered in the event of a breach”).

76. See, e.g., Holiday Hosp. Franchising, LLC v. Morning Star Hotel Victorville 4, LLC, No. 1:12-CV-3809-ODE, 2014 WL 11393569, at *9 (N.D. Ga. May 2, 2014) (enforcing formula used to calculate the liquidated damages that multiplied the number of rooms in the proposed Hotel by 500 then multiplied that fee by a factor of 2.5, finding the formula was a reasonable pre-estimate of the probable loss to the franchisor from the failure of the franchisee to open the hotel for a period of 20 months after entering into the franchise agreement); see also P.G.S., LLC, 2012 WL 3550764, at *7 (enforcing fixed liquidated damages amount of $250,000 where
the reasonableness of this type of provision, courts have in some cases presumed such provisions are reasonable.\textsuperscript{77}

Under the retrospective approach, the court will look at whether the calculated amount is a reasonable estimate of damages at the time of the breach.\textsuperscript{78} This analysis essentially turns on a comparison of the calculation of liquidated damages and the calculation of the franchisor’s actual damages.

\textit{b) The Role of Evidence of Actual Damages at the Time of Breach}

Many courts, particularly those that follow the prospective approach, deem evidence about actual damages immaterial to the analysis of whether the liquidated damages provision is enforceable.\textsuperscript{79} However, under the retrospective approach, the actual damage is a key consideration for deciding whether or not to enforce a liquidated damages provision. Even courts that apply the prospective analysis may sometimes consider the actual damages in determining whether or not a provision is reasonable.\textsuperscript{80} In some cases, the franchisor may present the amount of actual damages to support franchisor submitted evidence that recurring fees paid over an eight month period would be $160,000).

\textsuperscript{77} See, e.g., Howard Johnson Int'l, Inc. v. Tyler Texas Lodging, LLC, No. CV 15-3692, 2016 WL 3436402, at *4 (D.N.J. June 16, 2016) (awarding liquidated damages based on fixed fee per room because franchisee had not challenged calculation on motion for default judgment); Days Inns Worldwide, Inc. v. Hosp. Corp. of the Carolinas, No. 13-CV-8941 JPO, 2015 WL 5333847, at *4 (S.D.N.Y. Sept. 14, 2015) (holding that it was “reasonable for the parties to agree that [franchisor’s] liquidated damages would be based on the greater of two years’ Recurring Fees or a fixed sum of $2,000 per room (coupled with a reasonable cap on those damages)—especially since the [franchise agreement] had more than three years to run when it was terminated due to [franchisee’s] breaches”).

\textsuperscript{78} Guiliano v. Cleo, Inc., 995 S.W.2d 88, 99 (Tenn. 1999) (“[A] second approach has developed in which courts not only analyze the estimation of damages at the time of contract formation, but also address whether the stipulated sum reasonably relates to the amount of actual damages caused by the breach. Under this retrospective approach, the estimation of potential damages and the difficulty in measuring damages remain integral factors for the courts’ review. . . . However, as part of that review, the actual damages at the time of breach are also relevant in determining whether the original estimation of damages was reasonable.”) (collecting cases from jurisdictions that apply this approach).

\textsuperscript{79} Choice Hotels, Int'l, Inc. v. Chewl's Hospitality, Inc., 91 F. App’x 810, 817 (4th Cir. 2003) (“The fact that actual damages turn out to be less than those stipulated in the liquidated damages provision does not characterize or stamp the provision as a penalty unless it was so exorbitant as to clearly show that such amount was not arrived at as in a bona fide effort to estimate the damages that might have reasonably been expected to result from a breach.”); UPS Store, Inc. v. Hagan, No. 14CV1210, 2016 WL 1659188, at *2 (S.D.N.Y. Mar. 15, 2016) (“The amount of damages actually suffered has no bearing on the validity of the liquidated damages provision.”); Gator Apple, LLC v. Apple Texas Rests., Inc., 442 S.W.3d 521, 536 (Tex. App. 2014) (“If the amount of actual damages is made an issue in the enforcement of every contract with a liquidated damages provision, the very purpose of the agreement is undermined.”); DAR & Assocs., Inc. v. UniForce Servs., Inc., 37 F. Supp. 2d 192, 202 (E.D.N.Y. 1999) (“If a disparity between actual and liquidated damages has any relevance at all, it is only to the extent it sheds light on the reasonableness of the agreement viewed ex ante.”).

\textsuperscript{80} But see Guiliano, 995 S.W.2d at 99 (noting that under the prospective approach “the amount of actual damages at the time of breach is of little or no significance to the recovery of liquidated damages”).
its argument that the liquidated amount is reasonable. More often, however, it is the franchisee that presents evidence either that the franchisor will suffer no actual damages or that the amount of actual damage is significantly less than the liquidated amount, all in an effort to establish the calculation was not a reasonable estimate of potential damages.

There are several arguments franchisees can make based on actual damages. First, a franchisee may simply argue that the calculated amount of liquidated damages is far in excess of the actual damages—or there are no actual damages—rendering the liquidated damages calculation an unreasonable estimate of damages; this argument has been the most successful where it is supported by evidence of the actual damages. To the extent the franchised business has been unprofitable prior to the termination, a franchisee could argue that the business was unlikely to generate any future revenues for the franchisor and that the liquidated damages provision is therefore an unreasonable estimate of the actual damages to the franchisor. Under a retrospective approach, this argument might be compelling, because at the time of the breach, the franchisor could have expected very little in future royalty payments. However, under a prospective approach, this argument would be less compelling because at the time the parties entered the agreement, neither contemplated that the business would not be profitable. Moreover, this argument does not account for the loss to the franchisor beyond the royalty stream—the loss of goodwill and a presence in the market that will need to be replaced. At the same time, if there is evidence that the franchisor has no plans to replace the franchised business or is abandoning the market, the franchisee’s argument might be more persuasive.

81. See Downtowner/Passport Int’l Hotel Corp. v. Norlew, Inc., 841 F.2d 214 (8th Cir. 1988).
82. See, e.g., Dickey’s Barbecue Pit, Inc. v. Neighbors, No. 4:14-CV-484, 2015 WL 11199080, at *5 (E.D. Tex. Sept. 18, 2015) (concluding that liquidated damages provision was unenforceable because past royalty fees at time of termination totaled $5,463.00 and liquidated damages demanded totaled $676,122.55; because the “ratio of liquidated damages to actual damages is 123.58,” the court concluded the provision was an unenforceable penalty); Creative Am. Educ., LLC, 2015 WL 4655087, at *52, aff’d sub nom. Creative Am. Educ., LLC v. Learning Experience Sys., LLC, 668 F. App’x 883 (11th Cir. 2016) (refusing to enforce liquidated damages provision but noting that “[i]f it is shown that the franchisor did not actually suffer any harm as a result of the breach, in that particular case, the liquidated damages provision would be construed as a penalty”).
83. See La Quinta Corp., 603 F.3d at 340 (noting that losses to a franchisor from premature termination include “not only future royalties, but additional intangibles such as brand recognition and loyalty, and a competitive presence in a geographic region”).
84. But see Cusack Dev., Inc., 1999 WL 165702, at *8 (rejecting argument that liquidated damages were not proportional to the actual loss despite franchisee’s evidence that the franchisor opened a new hotel less than a year after termination and had been seeking replacement hotels in the market over a year prior to termination).
A franchisee might also argue that the period of time over which the future royalties are calculated is too long and, thus, the actual damages to the franchisor are far less than the liquidated amount. If the calculation is based on the balance of the term, without any limitation to account for how long it might take the franchisor to replace the franchised business or the calculation is based on a time period that exceeds the time remaining on the term of the contract, this argument might be compelling. However, even under those circumstances, courts have sometimes ignored what the actual damages might be for some lesser amount of time and enforced a liquidated damages provision calculating the lost recurring fees for the balance of the term.

Finally, when the liquidated damages are based on a fixed amount, courts may consider—but will often reject—the amount of actual damages in determining whether the liquidated amount is not a reasonable estimate and the provision is unenforceable.

3. What Courts Consider When Determining Intent

In states that require a showing that the parties intended to liquidate damages rather than impose a penalty for nonperformance, what constitutes sufficient evidence of intent varies. In most cases, the fact that the provision states that it is intended to calculate liquidated damages rather than impose a penalty is not conclusive; however, courts will often note such language in discussing the intent of the parties. Instead, courts will look at the agreement as a whole, the nature of the contractual relationship, and the type of breach that the liquidated damages seek to remedy. Courts may also con-

85. See, e.g., Dickey’s Barbecue Pit, Inc. v. Neighbors, No. 4:14-CV-484, 2016 WL 3878224, at *1 (E.D. Tex. Jan. 7, 2016) (holding liquidated damages provision was an unenforceable penalty because “[i]t forecasts twenty years of damages against a restaurant that was open for less than one year”); Lager’s, LLC v. Palace Laundry, Inc., 543 S.E.2d 773, 778 (Ga. Ct. App. 2000) (refusing to enforce liquidated damages provision that calculated payment for the full balance of the contract term); Guesthouse Int’l Franchise Sys., Inc. v. British Am. Props. Mac-Arthur Inn, LLC, No. 3:07-0814, 2009 WL 792570, at *3 (M.D. Tenn. Mar. 23, 2009) (holding that liquidated damages calculation was not reasonable to the extent it permitted the franchisor to “round up” and collect the amounts of fees due for an entire year instead of the amount due for the actual portion of the year remaining under the agreement’s term).

86. See, infra, notes 97–98.

87. See Days Inns Worldwide, Inc. v. Hosp. Corp. of the Carolinas, No. 13-CV-8941 JPO, 2015 WL 5333847, at *4 (S.D.N.Y. Sept. 14, 2015) (awarding liquidated damages based on capped fixed amount per room even though calculation of the sum of the accrued recurring fees for the twenty-four month period prior to termination of the franchise agreement was half of the liquidated amount); Days Inn of Am., Inc. v. Patel, 88 F. Supp. 2d 928, 935 (C.D. Ill. 2000) (rejecting franchisee argument that actual damages to franchisor were less than amount calculated based on a fixed amount per hotel room).


89. Id. (“Although the words used in the provision are by no means conclusive, they are a critical factor in determining the intent of the parties.”) (internal quotation marks omitted).

90. Id.
sider other circumstances, such as the prevalence of similar provisions in franchise agreements of nonparties in the same industry. As a result, the contract itself is critical to this determination, but evidence regarding the use of liquidated damages in other franchise agreements or within a particular industry may also serve as evidence of an intent to liquidate damages and not impose a penalty.

C. Other Potential Defenses to Enforcement

Aside from arguing that the provision is an unenforceable penalty because it is not a reasonable estimate of potential damage arising from a breach, there are very few other defenses to enforcement of a liquidated damages provision. In some cases, franchisees have argued that because the franchisor chose to terminate the franchise agreement, the franchisor should not be entitled to collect liquidated damages. Although that argument has been accepted by some courts in the context of claims for lost future royalties as damages arising from premature termination, courts have usually rejected that argument in the context of liquidated damages calculations.

In some cases, the franchisee has argued that the franchisor’s breach of the agreement or the implied covenant of good faith and fair dealing led to the termination and therefore the franchisor should not be permitted to recover liquidated damages. However, that challenge goes more to the propriety of the termination and whether or not the franchisor has a right to make a claim to recover liquidated damages, not whether the liquidated damages provision is enforceable. And absent evidence of an actual breach that would have foreclosed the franchisor’s right to terminate, courts are likely to reject this argument as well.

Franchisees have also argued that the liquidated damages clause should not be enforced or the amount should be reduced based on principles of mit-
igation.96 For example, where the liquidated damages provision calculates estimated future royalties for the balance of the term of the franchise agreement, as opposed to for some shorter period, franchisees have asserted that the provision does not account for the fact that if the franchisor were seeking lost future royalties as actual damages it would have an obligation to mitigate those damages. This is really just another way of arguing that the calculation is not a reasonable estimate of actual damages. Although several courts have deemed that argument compelling in the context of a franchisor seeking to recover lost future profits as actual damages for the balance of the franchise term,97 it does not appear that courts have followed this rationale with regards to liquidated damages provisions.98

As discussed earlier, franchisees have also argued that the franchisor can replace the franchised location in a time period that is less than the time period used in calculating the liquidated damages. Or, in some cases, there is evidence that the franchisor has replaced or is in the process of replacing the business. However, courts have routinely rejected this evidence, holding that the franchisor has no obligation to mitigate its damages when it seeks to recover under an otherwise enforceable liquidated damages provision.99

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96. See, e.g., Days Inn Worldwide, Inc. v. Sonia Investments, No. CIV.A. 304CV2278D, 2006 WL 3103912, at *7 (N.D. Tex. Nov. 2, 2006) (“Although [the franchisor’s] alleged failure to mitigate damages is only one element of the multi-faceted reasonableness inquiry, [the franchisee] may be able prove at trial that [the franchisor’s] failure to mitigate is substantial enough to render the damages fixed by the liquidated damages clause unreasonably large in light of actual loss.”).

97. See, e.g., Days Inns Worldwide, Inc. v. Miller, No. 3:16-CV-03004-RAL, 2017 WL 2829810, at *3 (D.S.D. June 29, 2017) (refusing to grant summary judgment on claim for fees for balance of the term of the franchise agreement as damages, despite addendum that required such payment upon termination for franchisee’s default, because fact issues existed about whether damages for balance of term were reasonable); HBS Family, Inc., 1998 WL 411334, at *8 (refusing to enforce fixed-amount-per-room formula and noting that “while [franchisor] is entitled to recovery of actual damages, it must show that it has mitigated its damages”).

98. See, e.g., Arif Enters., Inc., 2010 WL 5060289, at *10 (liquidated damages provision that calculated amount owed based on remaining term of each franchise agreement was reasonable estimate of potential damages absent any evidence from franchisees to the contrary); Century 21 Real Estate LLC v. Bercosa Corp., 666 F. Supp. 2d 274 (E.D.N.Y. 2009) (enforcing a liquidated damages provision in a franchise agreement that calculated royalty payments for the ninety-eight months remaining under the agreement); Shoney’s, Inc. v. Morris, 100 F. Supp. 2d 769, 776–77 (M.D. Tenn. 1999) (enforcing liquidated damages provision requiring payment of estimate royalties for balance of franchise agreements’ terms).

99. Days Inn Worldwide, Inc. v. Hazard Mgmt. Grp., Inc., No. 10 Civ 7545 (CM)(KNF), 2012 WL 5519356, at *3 (S.D.N.Y. Nov. 13, 2012) (rejecting argument by former franchisee that liquidated damages provision could not be enforced after franchisor entered agreement with a third party to operate the former franchisee’s hotel because “[w]hen a party signs a contract containing a liquidated damages clause, he is bound by it; recovery is a simple matter of contract and is not subject to equitable defenses or mitigation”); Majestic Towers, Inc., 488 F. Supp. 2d at 963 (“Requiring Radisson to prove its mitigation efforts would wholly undermine the rationale for employing liquidated damages provisions in the first place.”); Ramada Franchise Sys., Inc. v. Cusack Dev., Inc., No. 96 CIV. 8085 (MGC), 1999 WL 165702, at *8 (S.D.N.Y. Mar. 24, 1999) (“Regardless of the actual date on which a new Ramada was opened, the reasonableness of the liquidated amount under New York law must be assessed as of the time of contracting.”).
Some courts have refused to enforce liquidated damages provisions where the parties to the contract had unequal bargaining power.\textsuperscript{100} Evidence of unequal bargaining power turns on the sophistication and business experience of the franchisee as well as whether the franchisee had counsel in entering into the franchise agreement.\textsuperscript{101} However, most of those cases also found that the formula was not a reasonable estimate of the damages or that the calculation was not proportional to the actual damages and cited the unequal bargaining power as another issue.\textsuperscript{102}

Finally, note that both Minnesota and North Dakota prohibit the inclusion of liquidated damages provisions in franchise agreements.\textsuperscript{103}

V. Strategic Considerations

A. The Impact of Seeking Liquidated Damages on a Request for an Injunction to Enforce a Post-Termination Covenant Not to Compete

When a franchisor terminates a franchise agreement due to a franchisee’s default and the franchisee continues to operate in violation of a post-termination non-competition covenant, the franchisor will often sue and seek injunctive relief to enforce the non-competition covenant.\textsuperscript{104} Under the federal standard for obtaining injunctive relief, and under most state standards, the party seeking an injunction must show, among other things, that absent an injunction that party

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\textsuperscript{100} See, e.g., Rescuecom Corp. v. Chumley, No. 5:07-CV-0690, 2011 WL 1204758, at *10 (N.D.N.Y. Mar. 28, 2011) (“When analyzing the reasonableness of a liquidated amount, a court must . . . give due consideration to the nature of the contract and the attendant circumstances. . . . Relevant to this inquiry is the sophistication of the parties and whether both sides were represented by able counsel who negotiated the contract at arms length without the ability to overreach the other side.”).

\textsuperscript{101} Id. (“For example, Defendant Chumley was not represented by counsel, and the Franchise Agreement was non-negotiable. . . . Moreover, Defendant Chumley, while an educated individual with some industry experience, was not a sophisticated business person.”) (internal citations omitted).

\textsuperscript{102} Id. at *11 (“The dollar amount that [the franchisor] seeks to recover as stipulated damages . . . does not appear to bear a reasonable relationship to the pecuniary harm that Plaintiff most likely suffered as a result of [the franchisees’] breach.”).

\textsuperscript{103} Days Inn Worldwide, Inc. v. SBSB, LLC, No. CIV 08-6474 JRT/LIB, 2010 WL 3546958, at *5 (D. Minn. Sept. 7, 2010) (quoting Minn. Reg. 2860.4400(J)) (“It shall be unfair and inequitable for any person to . . . [r]equire a franchisee to waive his rights to a trial or consent to liquidated damages, termination penalties, or judgment notes.”); Securities Commissioner’s Policy Regarding Conduct that is Unfair, Unjust, or Inequitable to North Dakota Franchisees, BUS. FRANCHISE GUIDE (CCH) ¶ 5340.05 (“The Securities Commissioner Has Held the Following to be Unfair, Unjust or Inequitable to North Dakota Franchisees (Section 51-19-09, N.D.C.C.): . . . D. Liquidated Damages and Termination Penalties: Requiring North Dakota franchisees to consent to liquidated damages or termination penalties.”) (also available at http://www.nd.gov/securities/franchise-registration/franchise-registration-renewal).

\textsuperscript{104} Of course, a franchisor often will also seek injunctive relief to prevent unauthorized, post-termination use of its trademarks under the Lanham Act. The author is unaware of any case in which the presence of a liquidated damages provision was held to foreclose a franchisor from enjoining violations of the Lanham Act by a former franchisee.
will be irreparably harmed.\textsuperscript{105} Harm that is irreparable is harm that cannot be compensated by money damages alone.\textsuperscript{106} When courts determine that the injury can be remedied through a claim for damages, requests for injunctive relief are denied.\textsuperscript{107} Although courts do not always grant injunctions to enforce non-competition covenants in franchise agreements, most courts recognize that the harm resulting from the violation of a covenant not to compete—loss of goodwill, customers, etc.—is irreparable.\textsuperscript{108}

But what happens when the franchise agreement at issue also provides for liquidated damages in the event of a default and premature termination? Franchisees have argued that because the liquidated damages provision sets an amount that the franchisee must pay the franchisor in the event of a premature termination, the harm to the franchisor is compensable in monetary damages.\textsuperscript{109} Indeed, the franchisor has determined the amount of its damages.

The success or failure of this argument should really depend on how the franchise agreement is worded. Assuming the liquidated damages provision purports to calculate the franchisor’s damages arising from a premature termination, it should have no bearing on whether a violation of the noncompetition covenant can be enjoined. The damage flowing from the premature termination is the lost royalty revenue and expenses that will be incurred in replacing the franchised business.\textsuperscript{110} A violation of the post-termination noncompete is a separate breach for which there is a separate harm. In addition to the damages incurred from the loss of the franchised business in the market, there is the added harm that the former franchisee’s ongoing operation of its business will cause—namely, the unauthorized use of some or all

\textsuperscript{106} Id. at 82 (“Ordinarily, courts will not grant preliminary injunctive relief if the movant’s harm may be remedied through an award of money damages.”).
\textsuperscript{107} Id.
\textsuperscript{108} Id. at 125–26 (“[S]ome courts hold that there is a presumption of irreparable injury for breach of noncompete agreements.”) (collecting cases); Bad Ass Coffee Co. of Hawaii v. JH Enterprises, L.L.C., 636 F. Supp. 2d 1237, 1249 (D. Utah 2009) (“[T]he majority of courts that have considered the question have concluded that franchising companies suffer irreparable harm when their former franchisees are allowed to ignore reasonable covenants not to compete.”).
\textsuperscript{109} See, e.g., Harvey Barnett, Inc. v. Shidler, 143 F. Supp. 2d 1247, 1255 (D. Colo. 2001) (“Any difficulty in calculating damages . . . has been addressed by the Licensing Agreement. That Agreement includes a liquidated damages clause requiring Defendants to pay $50,000 for a breach of the Agreement . . . . Therefore, any loss to [the franchisor] is not “irreparable,” as [the franchisor] wrote the clause and chose the amount that it felt would compensate its loss. I therefore conclude that [the franchisor] has failed to meet its burden to show irreparable loss.”)
\textsuperscript{110} See, e.g., Bad Ass Coffee, 636 F. Supp. 2d at 1250 (“While the court agrees that there may be some circumstances in which a liquidated damages clause would make it clear that monetary damages are sufficient, this is not one of those cases. As discussed above [the franchisor’s] intangible assets, such as goodwill and the strength of its franchise, have been or will be damaged by Defendants’ breaches. This type of damage is difficult to measure in money. The court does not agree that the damages clause in the Franchise Agreement would be a reliable guide to attempt to do so.”).
of the franchisor’s operating system and the impediment that the former franchisee’s continued operation from the same location or in the same market will place on the franchisor’s effort to replace the franchised business and recoup its goodwill in the market. Moreover, the franchisor’s right to liquidated damages is no different whether the franchisee complies with a post-termination noncompete or violates that covenant. If the franchisor’s right to recover liquidated damages is independent of compliance with the noncompete, the liquidated damages are not a monetary calculation of the harm the franchisor will suffer if the franchisee violates the noncompetition covenant.

On the other hand, if the liquidated damages provision is drafted to address a breach of any covenant against competition (either in-term or post-term), then the franchisee likely has a much better argument that the franchise agreement contemplates redressing violations of the noncompetition covenants through damages rather than injunctive relief. However, at least one court has held that where the franchise agreement reserved to the franchisor the right to seek injunctive relief for violation of a noncompete in addition to providing for liquidated damages for breach of a noncompete, the franchisor could seek to enjoin the post-termination violation of the noncompete.\footnote{H&R Block Tax Servs. LLC v. Kutzman, 681 F. Supp. 2d 1248, 1253 (D. Mont.), order clarified sub nom. H&R Block Tax Servs. LLC v. Kutzman, No. CV 10-03-M-DWM, 2010 WL 11534361 (D. Mont. Feb. 23, 2010), and aff’d, 373 F. App’x 797 (9th Cir. 2010) (entering preliminary injunction against a franchisee to enforce post-termination covenants against competition and solicitation because “the fact that the agreement contains both a right to an injunction and liquidated damages does not mean the loss of goodwill is not irreparable, or that liquidated damages will provide an adequate remedy”).}

One additional caveat: a franchisor should be careful in using the liquidated damages calculation in its franchise agreement to calculate a “termination fee” that a franchisee must pay to mutually terminate the franchise agreement and allow the franchisee to exit the system. To the extent the franchisor also includes a waiver of the noncompete as part such agreements to terminate early, those agreements could be considered evidence that the franchisor considers the liquidated damages calculation to include the value of the noncompete. In that situation, a franchisee might have a good argument that injunctive relief is not available to the franchisor because the value of the noncompete is included in the liquidated damages formula because the franchisor has used that same formula to calculate a “termination fee” that includes a waiver of the noncompete.

B. The Impact on Recovery of Other Damages and Relief

Another consideration when seeking to enforce a liquidated damages provision is what impact it will have on the ability to collect other damages. Generally, courts will not permit a party to recover both the liquidated
amount and the actual damages arising from a particular breach.\textsuperscript{112} As a result, the impact of a liquidated damages provision on the availability of other damages or relief will depend on whether the additional damages or relief sought relate to the same breach or some different breach or wrongdoing. For example, courts have routinely held that franchisors can recover both liquidated damages for the premature termination of a franchise agreement and also recover damages, both contractual and under the Lanham Act, for failure to de-identify the franchised business after termination.\textsuperscript{113} However, courts will not permit a party to recover both liquidated damages arising from premature termination and lost future royalties for the balance of the franchise term.\textsuperscript{114} Nor are courts likely to award a franchisor its lost future royalties instead of awarding liquidated damages. If the franchisor includes the liquidated damages provision for certainty, it cannot later decide it would rather try to recover what might be a greater amount of lost future royalties in actual damages. Finally, where the liquidated damages provision applies to a variety of conduct but the calculation is the same regardless of the severity of the breach, the provision may not be deemed a penalty.\textsuperscript{115}

\textsuperscript{112} See Arcese v. Daniel Schmitt & Co., 504 S.W.3d 772, 784 (Mo. Ct. App. 2016), reh'g and/or transfer denied (Oct. 13, 2016), transfer denied (Dec. 20, 2016) (“[T]o avoid duplicative damages, generally, both liquidated damages and actual damages may not be awarded as compensation for the same injury.”); Super 8 Worldwide, Inc. v. Shri Narayan, LLC, No. CIV. 2:14-1034 KM, 2015 WL 4509813, at *6 (D.N.J. July 23, 2015) (“Because liquidated damages exist to compensate [the franchisor] for any forecasted recurring fees lost as a result of the premature termination of the Franchise Agreement, . . . [the franchisor] may only recover whatever recurring fees were unpaid as of the date of termination of the contract. Otherwise, the computed liquidated damages and recurring damages amounts would be duplicative in part.”).

\textsuperscript{113} See, e.g., La Quinta Corp. 603 F.3d at 344; Ramada Inns, Inc. v. Gadsden Motel Co., 804 F.2d 1562, 1566–67 (11th Cir. 1986). But see Travelodge Hotels, Inc. v. S.S.B. & Assocs., LLC, No. 14-CV-883 KM, 2015 WL 4530432, at *10 (D.N.J. July 27, 2015) (“[T]he Lanham Act infringement damages would be unfairly duplicative of [the franchisor’s] liquidated damages. Both are aimed at compensating [the franchisor] for the lost benefit of the franchise agreement, post-termination. Both are measured by the Recurring Fees that [the franchisor] would have, but did not, receive post-termination. And in both cases, the amount of such post-termination Recurring Fees is estimated with reference to the historical amount of fees received in the 24 months preceding termination.”).


VI. Conclusion

Under the more modern view, the question of whether a liquidated damages provision in a franchise agreement is enforceable is often answered “yes.” In that sense, the admonition of the authors of the 2001 Franchise Law Journal article that “courts should recognize the important benefit of these provisions for franchisors and franchisees alike”\textsuperscript{116} seems to have taken root. However, enforcement is not automatic; it requires careful drafting and evidentiary support to establish that the provision sufficiently satisfies applicable legal standards.

\textsuperscript{116} LaFiura & Sager, \textit{supra} note 2, at 175.
Location is indisputably one of the most important aspects considered by franchisors and franchisees when entering into a franchise agreement involving a brick and mortar business. The franchisor of such a business devotes substantial time, energy, and resources in pinpointing new development markets and vetting the viability of specific properties suggested by the franchisee. Likewise, a savvy franchisee will incur the costs of retaining a broker to locate a property that will meet the franchisor’s selection criteria and an attorney to assist with lease negotiations. Given that both the franchisor and franchisee devote such significant resources to site selection, it is important that both parties understand the intersections between franchising, real estate, and bankruptcy law and how such laws affect the parties’ rights when the franchise relationship ends or is disrupted by the franchisee’s bankruptcy filing.

Upon expiration or termination of the franchise agreement, it is common for the franchisor and franchisee to have competing interests when it comes to the real estate upon which the franchise operated. The franchisor may want to keep a valuable location in the system, either by operating the unit itself or by “flipping” it to another franchisee. Even if the franchisor does not want to continue operations at a particular location, the franchisor may want to prevent the franchisee or a third-party from exploiting the franchisor’s

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locational goodwill by reflagging the property as a competing business or by operating a competing business in close proximity to the location. In contrast, the franchisee may have remaining time on its lease term or feel entitled to build upon the locational goodwill by continuing to operate a competing business on or near the property.

Although more complicated structures exist, the large majority of real estate arrangements for franchise businesses can be broken down into one of three scenarios: (1) the franchisor leases (or subleases) property to the franchisee; (2) the franchisee leases property from a third-party landlord; or (3) the franchisee owns the property. This article addresses the ways in which franchisors and franchisees create, exercise, and defend their rights related to real estate in each of these scenarios.

I. Scenario One: Franchisor Leases Property to Franchisee

Some franchisors routinely act as landlords for their franchisees. Other franchisors avoid such an arrangement, but may nonetheless find themselves in the role of lessor or sublessor from time to time.

A. General Considerations

One of the most important preliminary safeguards for the franchisor is to include a cross-default provision in its leases and franchise agreements. In order to limit liability, the franchisee may use a separate entity to lease the property. In these cases, the franchisor should ensure that the cross-default provision contemplates a default by the tenant entity. If the provision only contemplates default by the named franchisee, then it may arguably not extend to the tenant entity. A well-crafted cross-default provision avoids a situation where the franchisor is hamstrung by its own agreements. This type of provision also gives the franchisor added leverage in the event the franchisee defaults under either the franchise agreement or the lease.

Further, where the franchisor wants to reserve the possibility of maintaining operations at the location after a lease default, the cross-default remedies should be structured in such a way that will facilitate a peaceful and seamless transfer of operations, as opposed to a scenario that may require an extended cessation of operations and an actual eviction that would leave all of the franchisee’s personal property on the curb in plain view. For example, a franchisor should ensure that the cross-default is triggered not upon the franchisee’s loss of possession of the premises, but upon the expiration of the franchisee’s opportunity to cure the lease default.

Of course, the franchisee may use any defenses it has with respect to a lease default in contesting the cross-default issued by the franchisor. Although a franchisor will likely be unwilling to negotiate the terms of a cross-default provision, the franchisee may seek to revise the provision to give itself more time before a cross-default is triggered. For example, the cross-default provision may state that a default under the other agreement
(e.g., a lease) triggers a default under the franchise agreement. The franchisee may want to revise this language to state that a cross-default is triggered only by a default under the other agreement that remains uncured after the required notice and opportunity to cure.¹ Cross-default provisions should also specifically address scenarios that the franchisor deems incurable.

Despite termination or expiration of the franchise agreement, the franchisee may continue to operate at the location (so-called “holdover franchisees”). In order to protect the goodwill of the brand, the franchisor should quickly seek a preliminary injunction (as explained in more detail later in Section III) and simultaneously initiate a proceeding to evict the franchisee from the premises. In most jurisdictions, prior to filing a dispossessory action, the franchisor-landlord must send a written demand that the franchisee-tenant pay the amount owed and/or return the premises to the franchisor. Then, if the franchisee fails to comply, the franchisor can file a dispossessory complaint. Once the franchisee is served with the complaint, it has a certain number of days (depending upon the jurisdiction) to file an answer. In most jurisdictions, if the franchisee fails to file an answer, the franchisor can apply for a writ of possession and, once granted by the court, schedule the eviction. If the franchisee files an answer, the court will set a hearing on the matter. If the franchisor prevails at the hearing, the franchisor is entitled to both a writ of possession and money judgment for the amount owed.² The franchisor can then move forward with scheduling the eviction. Generally, the amount recoverable in the dispossessory proceeding is limited to the amount owed under the lease and will not include amounts owed under the franchise agreement. In addition, depending upon the jurisdiction and language of the lease, the franchisor may be able to evict the franchisee without terminating the lease so that the franchisee remains liable for rent accruing under the lease.³

¹. The franchisor should also include a purchase option provision in the franchise agreement so that it can elect to purchase the assets of the franchise from the franchisee upon expiration or termination of the franchise agreement. Purchase option provisions are discussed in more detail later in Section II.

². In some jurisdictions, the franchisee does not have to be personally served with the dispossessory complaint. See, e.g., Perryman v. Lucas, 626 S.E.2d 550, 551 (Ga. Ct. App. 2006); Dolben Co. v. Friedmann, 2008 Mass. App. Div. 1 (Dist. Ct. 2008); Living Life Invs. v. Wood, No. 2017-0029, 2017 WL 5951598, at *2 (N.H. Oct. 13, 2017). In such jurisdictions, if the franchisee is not personally served and fails to file an answer, the franchisor may be able to obtain only a writ of possession and not a money judgment.

³. See Hardin v. Kirkland Enter., Inc., 939 So. 2d 40 (Ala. Civ. App. 2006) (“Although the general rule is that when a landlord evicts a tenant and takes possession of premises, the lease is terminated and the right to claim rent which accrues after eviction is extinguished, the parties to a lease may contract to hold a lessee liable for post-eviction rent.”); McArthur v. Rostek, 483 P.2d 1351 (Colo. Ct. App. 1971) (“termination of lease agreement or eviction of tenant by landlord relieves tenant from all liabilities to accrue in the future, including rent, except where the parties, by express agreement, have contracted to the contrary”); McIntosh v. Gitomer, 120 A.2d 205 (D.C. Mun. Ct. of Appeals 1956) (“a covenant in a lease imposing liability for rent on tenant after eviction for default is valid, but such liability is one for damages and not for rent”).
Although a franchisee may have counterclaims against the franchisor, such claims will usually not delay an eviction proceeding based on the non-payment of rent because the obligation to pay rent under common law runs with the land and is generally independent from any obligations the franchisor may have under the lease or the franchise agreement.\(^4\) Further, while delaying an eviction may be near impossible for the franchisee that has not paid its rent, in some jurisdictions the franchisee may be able to avoid the entry of a money judgment in the course of the dispossession proceeding by not filing an answer when there has been no personal service.\(^5\)

In some instances, the franchisee may cease operations but leave personal property on the premises. In these circumstances, the franchisor may want to use self-help remedies in order to cut down on its time and cost; however, the legality and requirements of such remedies vary considerably between jurisdictions. The franchisor should always include language in both the franchise agreement and the lease stating that the franchisor is entitled to utilize self-help remedies. However, it is important for the franchisor to understand the law of the applicable jurisdiction before taking any action, because utilizing self-help remedies incorrectly could subject the franchisor to liability for actual and punitive damages.\(^6\)

In many jurisdictions, franchisors can utilize self-help to remove the franchisee’s property if they do not breach the peace.\(^7\) Even in such circumstances, the use of these remedies can be risky if not clearly supported by the language of the lease and franchise agreement. Some jurisdictions also allow the parties to contractually waive the requirement that the franchisor-landlord complete eviction proceedings before removing the franchisee’s personal property.\(^8\) Nonetheless, the most conservative course of action is for the franchisor to obtain a writ of possession before removing the franchisee’s personal property. As a practical matter, employing the court’s dispossessionary tools

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5. See, e.g., GA. CODE ANN. § 44-7-51(c) (West 2018).


may operate as an insurance policy to protect the franchisor from claims by the tenant or third-party lienholders for damage to or conversion of personal property, including secured personal property. Generally, once the eviction is complete, any of the franchisee’s personal property on the premises is deemed abandoned and may be removed/dispossessed without risk of liability.

Of course, in most scenarios where the franchisor intends to maintain operations at a formerly franchised location, the franchisor will want to avoid eviction proceedings and take over operations in a seamless fashion and without the location going dark. Purchase options, lien rights, and other take-over remedies in the franchise agreement will often provide the authority for facilitating a seamless takeover without a gap in operations. However, regardless of the provisions in the franchise agreement, the franchisor should always search the UCC filings to determine if any third-party lenders have a security interest in any of the furniture, fixtures, and equipment located at the premises. The franchisor’s take-over remedies in the franchise agreement will be subject to any superior third-party liens on the franchisee’s personal property and improvements. Although a state’s UCC laws will provide the procedure for liquidating encumbered assets, as a practical matter, lenders, franchisors, and landlords are often motivated and able to resolve these issues amicably without resorting to public sales. And although third-party lienholders may be motivated to negotiate a pay-off of the debt in order to release the lien and avoid the cost of liquidation, franchisors should factor in the cost of the encumbered assets when evaluating whether to try to maintain operations at the franchised location.

B. Considerations Specific to Bankruptcy

When the franchisor assumes the role of lessor or sublessor, the franchisor takes on additional risks in the event that the franchisee files for bankruptcy.9 In the leasing and franchise context, bankruptcy is often used as a strategic play by the franchisee to renegotiate executory contracts, such as unexpired franchise agreements and leases. Among other tools available to a debtor under the Bankruptcy Code, Section 365 provides a debtor with the powerful right to reject a franchise agreement (or an executory contract) and avoid certain contractual consequences related to the agreement or contract.10

The prudent franchisor, however, can make front-end strategic credit enhancement decisions to secure its real estate position to effectively leverage

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9. See Susan V. Metcalfe, Location, Location, Location: Effect of the Franchisee’s Bankruptcy on the Franchisor’s Control of Real Estate, 37 FRANCHISE L.J. 233, 235, 242 (2017) (analyzing In re Karfakis, 162 B.R. 719 (Bankr. E.D. Pa. 1993) and the associated risk of a franchisee reviving a terminated franchise agreement in the bankruptcy context when the lease and franchise agreement are found to be an integrated contract such that, despite a pre-petition termination of the franchise agreement, the franchisee-debtor maintains reorganization rights under the lease, including reinstating or assuming the franchise agreement under § 365 of the Bankruptcy Code).
its rights, irrespective of whether a bankruptcy is filed by its franchisee. In bankruptcy proceedings, leverage begets control, and a franchisor can protect its brand by structuring recourse options that remain unaffected by any tenant bankruptcy filing and minimize the tenant-debtor’s most powerful tools under the Bankruptcy Code.

1. The Best Defense Is a Good Offense: Third-Party Recourse

The franchisor, as a creditor, can best protect its financial position and control over its brand by structuring agreements with a franchisee that contemplate the reach of an automatic stay in the event of a bankruptcy filing. The most fundamental tenet of the bankruptcy process is the imposition of the automatic stay, which immediately goes into effect upon the filing of a bankruptcy petition.\(^{11}\) The automatic stay disrupts most contractual remedies and halts pending litigation to further two central purposes of the bankruptcy reorganization process—to preserve any going-concern value of the debtor and to assure equality of distribution as to all creditors. However, by applying the adage that the best defense is a good offense, a franchisor can minimize the impact of an automatic stay by obtaining a standby letter of credit and affiliate guarantees when the lease or sublease is entered into.\(^{12}\)

Letters of credit provide the franchisor recourse to a third party that falls outside the reach of the automatic stay. “Fundamental to the letter of credit transaction is the principle that the issuing bank’s obligation to honor drafts drawn on a letter of credit by the beneficiary is separate and independent from any obligation of its customer to the beneficiary under the sale of goods contract and separate as well from any obligation of the issuer to its customer under their agreement.”\(^{13}\) Because the letter of credit is an obligation of the non-debtor issuing bank, the automatic stay does not prevent the franchisor, as the letter of credit beneficiary, from drawing on the letter even after a bankruptcy case is filed.\(^{14}\)

\(^{11}\) 11 U.S.C. § 362. Section 362(a) contains a long list of actions that are stayed by the filing of a bankruptcy petition. The prohibited actions include those that tend to be of most concern to creditors. For example, after a debtor files for bankruptcy, a creditor cannot commence or continue litigation against the debtor to recover on claims that arose before the petition date. A lawsuit that has been filed against the debtor prior to the petition date must be stayed as to the debtor.

\(^{12}\) “Letters of credit are commercial instruments that provide a seller or lender (the beneficiary) with a guaranteed means of payment from a creditworthy third party (the issuer) in lieu of relying solely on the financial status of a buyer or borrower (the applicant).” Nissho Iwai Europe v. Korea First Bank, 782 N.E.2d 55, 58 (N.Y. 2002); see also 3Com Corp. v. Banco do Brasil, S.A., 171 F.3d 739, 741 (2d Cir. 1999).

\(^{13}\) 3Com Corp., 171 F.3d at 741.

Additionally, the majority of courts hold that the scope of the automatic stay does not extend to non-debtor guarantors.\(^\text{15}\) As such, obtaining guaranties from the franchisee’s principal or other related entities likely limits the reach of the automatic stay upon any bankruptcy filing by the tenant-franchisee. Under the majority view, franchisors exercising their rights as to guarantors are not limited by the automatic stay. As the Third Circuit has explained, “the automatic stay is not available to nonbankrupt codefendants of a debtor even if they are in a similar legal or factual nexus with the debtor.”\(^\text{16}\) The majority of bankruptcy courts are generally in accord. For example, in \textit{In re Mur\textasciitilde all}, the debtor’s request to extend the automatic stay to its principals, who also served as its guarantors, was denied on both legal and equitable grounds.\(^\text{17}\) The court stated, “[i]f this Court were to grant the Debtor’s requested relief [under § 362], it would, in effect, create an automatic stay for non-debtor guarantors in a Chapter 11 proceeding. Such a stay was not intended by Congress.”\(^\text{18}\)

The savvy franchisor can also minimize its exposure in a tenant bankruptcy by including an ipso facto clause in the guaranty agreements. An ipso facto clause is a default provision that permits a termination due to the bankruptcy, insolvency, or financial condition of a party. Although ipso facto clauses are generally unenforceable in bankruptcy,\(^\text{19}\) an ipso facto clause in an agreement with a non-debtor party does not allow the non-debtor party to avail itself of the Bankruptcy Code provisions outside of bankruptcy.\(^\text{20}\) By including an ipso facto clause in a guaranty agreement with a non-debtor, the franchisor positions itself to maintain its right to bring or threaten an independent suit against the lease guarantors based on the debtor’s breach of the ipso facto provision. Exerting leverage and financial pressure outside of the bankruptcy context also typically results in more control and concessions by the debtor within the bankruptcy.

In summary, when assuming the landlord role, obtaining a third-party guaranty specific to the franchisee’s obligations under the lease may give the franchisor greater influence in the bankruptcy proceeding based on the ability to pursue remedies against the guarantor without running afoul of the automatic stay. A franchisor must be mindful, however, of the minority view with respect to guarantors\(^\text{21}\) and the interplay of indemnification obli-

\(^{15}\) Absent unusual circumstances, the automatic stay also does not typically apply to sureties, insurers, partners, and other persons liable on the debt. See, e.g., Nat’l Tax Credit Partners, L.P. v. Havlik, 20 F.3d 705, 707 (7th Cir. 1994).


\(^{18}\) Id.

\(^{19}\) 11 U.S.C. § 365(e)(1).

\(^{20}\) See, e.g., Schumacher v. White, 429 B.R. 400, 408 (E.D.N.Y. 2010) (a “bankruptcy proceeding is meant to protect the debtor, not third-party guarantors.”).

\(^{21}\) E.g., Lazarus Burman Assoc. v. Nat’l Westminster Bank USA (\textit{In re Lazarus Burman Assoc.}), 161 B.R. 891 (Bankr. E.D.N.Y. 1993) (applying the automatic stay and enjoining creditor from pursuing guaranty action because the guarantor would fund debtor’s reorganization).
gations between a guarantor and the debtor when bankruptcy courts determine the reach of the stay.22

2. Secure Your Status

Landlords typically qualify as an administrative expense priority creditor in a reorganization plan because the debtor’s ongoing use of a leased premises is deemed “actual” and “necessary” to preserve the estate.23 However, a landlord can also position itself as a secured creditor by including in the lease a consensual security interest created pursuant to the UCC. Although a landlord’s lien is limited in a bankruptcy proceeding, a properly perfected security interest can afford a landlord secured remedies against a defaulting tenant with enforceable liens on the tenant’s property.

The applicable state’s version of Article 9 of the UCC governs security interests in personal property and fixtures, including goods, instruments, equipment, general intangibles, chattel papers, or accounts. A security agreement in the lease must include express language to create a consensual security interest in the tenant’s property under the applicable state’s version of Article 9. The franchisor should also be mindful that maintaining priority and perfecting a security interest requires that the landlord file the corresponding financing statement with the proper recording office as required by revised Article 9.

By obtaining secured status in a bankruptcy proceeding, franchisors can safeguard their financial position and exert greater control over the case. The Bankruptcy Code affords secured creditors additional rights, including assurances of adequate protection, limited impairment under a Chapter 11 plan of reorganization, credit bidding rights, priority upon conversion to Chapter 7, and, in some instances, recovery of attorneys’ fees.24 The reach of a secured creditor’s control can be illustrated within the context of cash collateral. For example, a secured creditor has rights to object to the debtor’s use of cash collateral, which is defined as cash or cash equivalents, including proceeds.25 Typically, a debtor will need immediate access to cash when it

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22. A.H. Robins Co. v. Piccinin, 788 F.2d 994, 997 (4th Cir. 1986) (imposing the automatic stay on non-debtor codefendant where the codefendant also had indemnification rights against the debtor).

23. See, e.g., Zagata Fabricators, Inc. v. Superior Air Prods., 893 F.2d 624, 627–28 (3d Cir. 1990) (“the landlord may claim first priority as a creditor to whom the debtor owes rent as an ‘actual, necessary cost[ ] . . . of preserving the estate’”) (citing 11 U.S.C. §§ 503, 507)); 11 U.S.C. § 503 (“(b) After notice and a hearing, there shall be allowed administrative expenses, . . . including—(1)(A) the actual, necessary costs and expenses of preserving the estate . . .”).


25. 11 U.S.C. § 363(a) (“In this section, ‘cash collateral’ means cash, negotiable instruments, documents of title, securities, deposit accounts, or other cash equivalents whenever acquired in which the estate and an entity other than the estate have an interest and includes the proceeds, products, offspring, rents, or profits of property and the fees, charges, accounts or other payments for the use or occupancy of rooms and other public facilities in hotels, motels, or other lodging properties subject to a security interest as provided in § 552(b) of this title, whether existing before or after the commencement of a case under this title.”).
files for bankruptcy and must either gain the secured creditor’s consent to use cash collateral or obtain a court order over the secured creditor’s objection.\footnote{26} As a result, at the very inception of a bankruptcy, secured creditors have built-in protections that have the practical effect of exerting control over the debtor’s operations, which in the case of a franchisor may mean thwarting a debtor’s attempt to use the bankruptcy process to reorganize and reflag or reorganize as a competing concept.

3. Artfully Defining Rent and Use in the Lease

In the role of a landlord, a franchisor can maximize its recovery in a tenant bankruptcy by carefully drafting lease terms, including what constitutes rent under the lease. The Bankruptcy Code refers to “rent” or “rent reserved” in a number of relevant provisions and there is an entire body of case law as to whether certain costs and fees qualify as “rent” under the Bankruptcy Code.\footnote{27} To determine whether the Bankruptcy Code’s rent provisions are applicable, courts look to the terms of the lease and applicable state law to determine what types of charges can be captured in unpaid “rent.”\footnote{28} Well-drafted rent definitions and use of the term “additional rent” to capture real estate taxes, CAM charges, percentage rent, insurance, and utilities may best position a franchisor in certain jurisdictions.

The franchisor should also outline permitted and prohibited uses by the franchisee-tenant under the lease. Section 365 of the Bankruptcy Code requires assumption of all the lease terms, so a use clause can provide a tactical negotiating and litigation advantage where the tenant files bankruptcy and seeks to assign the lease to a competing entity.\footnote{29} Carefully drafted use provisions can be advantageous to a franchisor-landlord and may also mitigate reflagging risks in bankruptcy, particularly since anti-assignment clauses are generally held to be unenforceable in bankruptcy.\footnote{30}

28. See, e.g., In re MDC Syst., Inc., 488 B.R. 74 (Bankr. E.D. Pa. 2013) (analyzing whether CAM charges should be designated as “rent reserved” and available to landlord on its claim).
4. Short fuses

A franchisor’s practice of swift action regarding defaults and cure periods can also limit its exposure to a tenant bankruptcy. Tenants tend to more seriously contemplate bankruptcy after they receive a notice of default. If the franchisor is able to terminate the lease prior to the franchisee filing for bankruptcy, the franchisee generally cannot assume and assign its rights under the lease.31

By contemplating the impact of a tenant bankruptcy at the outset when agreements are entered into, a landlord can create third-party agreements and favorable lease terms to minimize the disruption and impact of a tenant bankruptcy. More importantly, creating leverage within a bankruptcy proceeding greatly reduces the potential the loss of location or loss of brand control that are critical concerns to a franchisor.

II. Scenario Two: Franchisee Leases from Third-Party Landlord

The most common scenario for obtaining real estate for a franchise business is for the franchisee to lease property from a third-party landlord. The franchisor should ensure that the franchise agreement includes a provision allowing the franchisor to request information from the landlord and to respond to requests from the landlord. An example of such a provision is:

Franchisee hereby irrevocably grants Franchisor permission to (a) release to Franchisee’s landlord, lender(s), or prospective landlord(s) and lender(s) any financial or operational information relating to the Franchised Unit; however, Franchisor is under no obligation to do so; and (b) request information from Franchisee’s landlord(s) and lender(s). Franchisee also irrevocably authorize such landlord(s) and lender(s) to respond to any and all questions from Franchisor and provide Franchisor with all information requested regarding Franchisee.

This type of provision gives the franchisor insight into the franchisee’s complete financial picture and the ability to begin negotiations, if necessary, with the franchisee’s landlord upon expiration or termination of the franchise agreement.

A. Franchisor Wants Franchisee to Cease Operations and De-Identify

Most franchise agreements contain provisions requiring the franchisee to cease operations and de-identify the premises upon expiration or termination of the agreement. Many franchise agreements also provide the franchisor with the right to enter the premises and remove signage bearing franchisor’s marks if the franchisee fails to do so. In circumstances where the franchisor must de-identify the premises, the franchisor should communicate with the

31. E.g., Moody v. Amoco Oil Co., 734 F.2d 1200, 1213 (7th Cir. 1984); see also In re Tornado Pizza, LLC, 431 B.R. 503, 510–11 (Bankr. D. Kan. 2010); In re Greenville Am. Ltd. P’ship, 2000 WL 33710874, at *4 (Bankr. D.S.C. Mar. 24, 2000) (“Executory contracts or leases that terminated prepetition are no longer available for assumption or rejection under § 365 because there is nothing left for the debtor to assume.”); but see Metcalfe, supra note 9, at 242.
landlord to ensure the franchisor does not expose itself to liability for trespass. As a more proactive approach, the franchisor can request the landlord enter into a lease rider contemporaneous with the execution of franchisee’s lease that gives the franchisor the right to enter the property without liability for trespass. Such a lease rider should also give the franchisor the express ability to de-identify the premises. In the absence of a lease rider or permission to enter the premises from the landlord, the franchisor may need to seek a court order to force the franchisee and/or landlord to remove signage or to permit the franchisor to remove signage. Although there is substantial case law supporting the franchisor’s rights to force the franchisee to de-identify, there is no similar body of law supporting the franchisor’s right to force a landlord to de-identify in the absence of a contractual obligation to do so.

In addition to circumstances where the franchisee does not de-identify a closed business, the franchisor will eventually face a situation where the franchisee continues to operate the business using the franchisor’s marks even though the franchise agreement has expired or been terminated. The franchisee may have not yet defaulted under its lease and, therefore, the landlord may not take action to evict the franchisee. The franchisee likely no longer has access to the franchisor’s proprietary products and, therefore, will not be abiding by the franchisor’s system standards. The franchisor must take quick action to address this situation because there is a substantial risk of damage to the franchisor’s goodwill.

The franchisor should promptly seek a preliminary injunction to stop the continued infringement of its trademarks or trade secrets (i.e., force franchisee to immediately cease operations and de-identify). In addressing whether to grant the preliminary injunction, the federal court will analyze four factors. First, the court will determine if the plaintiff has shown that it is likely to succeed on the merits. Second, the court will determine if the plaintiff is likely to suffer irreparable harm if the court does not grant the injunction. Third, the court will balance the equities of the case and, fourth, the court


33. Depending upon the facts of the particular case, it may be possible to bring a claim against the landlord for indirect trademark infringement under the Lanham Act. There is no case law directly on point; however, the available case law relating to the liability of property owners appears to indicate that a landlord could be held liable under certain circumstances. See Polo Ralph Lauren Corp. v. Chinatown Gift Shop, 855 F. Supp. 648 (S.D.N.Y. 1994) (trademark holder prevailed on landlord’s motion to dismiss contributory infringement claim where landlord knew infringer was selling counterfeit goods on the premises); but see Coach, Inc. v. Swap Shop, Inc., 916 F. Supp. 2d 1271 (property ownership alone is insufficient to establish contributory infringement). When the franchised business is non-operational, it could be difficult to prove that the landlord is facilitating infringement in commerce, which is required to prevail on a trademark infringement claim.

will consider the effect on the public if the injunction is granted or denied. Permanent injunctive relief involves the same elements as preliminary injunctive relief except the moving party must have prevailed on the merits.  

In response to a franchisor’s motion for preliminary injunction, the franchisee often challenges the likelihood of success on the merits by disputing the propriety of the termination. Some courts have held that even if the franchisor improperly terminated the franchise agreement, the franchisee’s remedy is a claim for damages and not the right to continue with the unauthorized use of the franchisor’s trademarks. Other courts however have found that if the enforcement of the franchisor’s termination rights, even on a temporary basis, will have the practical effect of causing the franchisee to permanently close its doors, the franchisee may be entitled to an order enjoining the franchisor’s termination rights pending a decision on the merits. The franchisee will also likely point to the loss of jobs when balancing the equities under the third prong, as well as any delay by the franchisor in enforcing its termination rights when addressing whether there is truly an imminent threat of irreparable harm under the second prong of the analysis.

If the franchisee is no longer using the franchisor’s marks, but is operating a competing business (on the same property or at another prohibited location), the franchisor often seeks to enforce post-term restrictive covenants against the franchisee. The franchisee, on the other hand, may feel entitled to continue to use utilize the skills and goodwill that it obtained during the course of operating the franchised business. Most franchise agreements include a provision limiting the franchisee’s ability to participate in a competing business within a specified territory for a specified time period after expiration or termination of the agreement. The franchisor should also include these restrictions in any separate non-competition agreements that the franchisor obtains from individual owners or managers of the franchisee entity. The enforceability of such restrictive covenants varies considerably by state. The franchisor should take into consideration the enforceability of its restrictive covenants when drafting these provisions and when determining the governing law of the franchise agreement. Generally, in analyzing the enforceability of such covenants, the courts will look at whether the restrictions are reasonable in terms of duration, geographic limit, and the scope of prohibited competition. Some courts have the ability to “blue pencil” overly broad restrictive covenants, but other courts simply render such provisions

35. See generally eBay, 547 U.S. 388.
The franchisor can include language allowing it to reduce the scope of the restrictive covenant to try to avoid a court finding the provision unenforceable.\footnote{Stonhard, Inc. v. Carolina Flooring Specialists, Inc., 621 S.E.2d 352 (S.C. 2005); Becham v. Synthes USA, 482 F. App’x 387 (11th Cir. 2012).} The franchisor may want to include a restrictive covenant that encompasses the franchisee’s family members, affiliates, and even future tenants of the premises.\footnote{The franchisor may try to negotiate a lease rider with a landlord that incorporates the restriction on leasing to a competing business for a certain period of time after the termination or expiration of the franchise agreement. Unsurprisingly, the landlord may be hesitant to limit itself in this way and the franchisor’s success in getting this lease rider will depend on parties’ respective leverage. If the franchisee owns the property, the franchisor may want to make sure that the restrictive covenant is broad enough to cover the situation where the franchisee (after termination of the franchise agreement) may seek to lease the property to a business that, if operated by the franchisee directly, would violate the terms of the restrictive covenant.} In many jurisdictions, courts have enjoined individuals and businesses working with the franchisee to evade the restrictive covenants, even if such individuals or businesses did not sign the franchise agreement or a separate non-compete agreement.\footnote{See generally Emma Cano, Darci E. Cohen & Diane Green-Kelly, Unsigned Obligations: When Are Non-Signatories Bound? ABA 37th FORUM ON FRANCHISING W-2 (2014), https://www.americanbar.org/content/dam/aba/administrative/franchising/materials2014/w2.authcheckdam.pdf; Alison McElroy & Nicole S. Zellweger, Guaranties and Other Franchisee Undertakings: Negotiation, Drafting and Enforcement Issues, ABA 37th FORUM ON FRANCHISING W-13 (2014); Michael Gray & Jason Murray, Covenants Not to Compete and Non-signatories: Enjoining Unfair Conspiracies, 25 FRANCHISE L.J. 107 (2006).} The franchisor may refuse to negotiate the restrictive covenant; however, the circumstances of the deal may provide the franchisee with leverage to make some meaningful changes. The franchisee may want to revise the provision to limit (1) the geographical scope, (2) the time frame, (3) the individuals bound by the provision, and/or (4) the types of businesses that qualify as prohibited “competitive businesses.” The franchisee may also want to modify the provision to allow the franchisee to hold up to a certain amount of interest in a publicly traded company. In the event the franchisee files for bankruptcy, the enforceability of restrictive covenants varies by court and whether the non-compete provision is otherwise effective under applicable law.\footnote{See In re Klein, 218 B.R. 787 (Bankr. W.D. Pa. 1998) (holding that a non-compete clause is enforceable in bankruptcy if it is enforceable under applicable law); Sir Speedy, Inc. v. Morse, 256 B.R. 657, 660 (D. Mass. 2000) (explaining that within the context of the debtor’s rejection of a franchise agreement in bankruptcy, post-contractual obligations under the franchise agreement do not “magically vanish” in bankruptcy).}
B. Franchisor Wants to “Step In” to Franchisee-Tenant’s Lease

Upon expiration or termination of the franchise agreement, the franchisor may want to step in and operate the franchisee’s business or install a new franchisee in the location. The franchisor’s rights to take over a business under the franchise agreement may conflict with the landlord’s rights to dispossess the franchisee-tenant for non-payment of rent. The franchisor could try to negotiate a new lease with the landlord upon termination of the franchise agreement; however, there is no guaranty the franchisor and landlord will be able to agree on terms.

As an alternative, the franchisor may want to request that the landlord enter into a collateral assignment of lease agreement (CAOL) contemporaneous with the execution of the franchisee’s lease. The CAOL acts as a separate, contingent lease that becomes effective immediately upon the franchisor exercising its rights under the franchise agreement to terminate and take over the business. In bankruptcy, courts are divided as to the treatment of a CAOL; the franchisor’s ability to enforce its rights will depend on whether the debtor rejects the CAOL and whether the court views the CAOL and franchise agreement as an integrated contract.

The CAOL should include a provision requiring that the landlord give notice to the franchisor in the event of default by the franchisee so that the franchisor can decide whether to exercise its rights under the CAOL. The franchisor will want to ensure that the CAOL does not require that the franchisor be responsible for past-due amounts owed by the franchisee under the lease. If the landlord demands the franchisor agree to some type of cure obligation, the franchisor may still be able to negotiate a cap on the amount. If the CAOL contains a cure obligation, the franchisor should include language (either in the CAOL or franchise agreement) stating that any amounts paid by franchisor to cure the default will be recoverable from the franchisee.

The franchisor should also be aware of the assignment provisions in the franchisee’s lease because, in the event the franchisor exercises its rights under the CAOL, the franchisor may want the right to assign the lease to an affiliate or a new franchisee without retaining any liability thereunder. The landlord may require language stating that its consent will not be required if the assignee meets certain agreed-upon criteria, including net worth and experience in the relevant industry. The franchisor should also be aware of the monthly rental amount under the franchisee’s lease to ensure that it is reasonable. If the rent is too high, it might be financially impractical for the franchisor to continue to operate the franchise under the lease.

44. If the landlord has a mortgage on the property, the franchisor may also ask that the franchisee, landlord, and the landlord’s mortgagee enter into a Subordination, Non-Disturbance and Attornment Agreement. Such agreements are discussed in more detail later in Section III.

45. See Metcalfe, supra note 9, at 243.
When the franchisor “steps-in” to the franchisee’s lease and gains control of the property, it may also want to take possession of the furniture, fixtures, and equipment (FF&E) left behind by the franchisee. The franchise agreement should include a provision granting the franchisor a security interest in the FF&E and preclude the franchisee from granting a security interest in the FF&E to others. The franchisor may be forced to remove such a provision if the franchisee is obtaining financing to start the franchised business because the lender is likely to want a security interest in the FF&E. Assuming the franchisor does not subordinate its interest to that of the lender, if the franchise agreement is terminated and the franchisee owes money to the franchisor, the franchisor will be able to foreclose on its security interest and take possession of the FF&E, subject to the procedural requirements of the applicable state law, which may or may not adopt the UCC. Even with such a provision in the franchise agreement, the franchisor should investigate whether any other parties have superior claims to the FF&E before it takes possession pursuant to a security interest or purchases the FF&E from the franchisee. For example, a lender may have a first priority lien on equipment and want to sell the equipment pursuant to a security agreement, the landlord may have a statutory lien on FF&E due to unpaid rent, or the state in which the franchise is located may have a tax lien on the property. If the franchisee does not owe money to the franchisor, but the franchisor nevertheless wants to take possession of the FF&E, the franchisor will need to purchase the FF&E from the franchisee at the price set forth in the franchise agreement (presumably, fair market value).

As discussed earlier in Section I.B., in bankruptcy, the franchisor can improve the classification of its claim by having a valid and perfected security interest. A secured creditor in bankruptcy has much more leverage and control than a general unsecured creditor. For example, under § 363(a), the debtor-in-possession cannot use cash collateral without a secured creditor’s approval or proving to the court that the creditor is adequately protected. A debtor frequently establishes adequate protection by granting the secured creditor a post-petition replacement lien. The practical result of this dynamic is that a secured creditor immediately achieves a better financial position in the bankruptcy proceeding and gains substantial control over the debtor’s operations in the bankruptcy. Having some control over the debtor’s reorganization drastically mitigates against any attempt a debtor may make to assign the franchise agreement to an undesirable franchisee or eliminate the franchise location altogether. As such, the franchise agreement should provide the franchisor with a valid security interest and the franchisor should take additional steps to perfect and monitor its liens because in bank-

46. Depending upon the language of purchase option provision in the franchise agreement, the franchisor may also be able to purchase the franchisee’s interest in any FF&E leases.

ruptcy unperfected liens can be avoided. Therefore, for the franchisor to successfully achieve the status of a secured creditor, it must have perfected liens through valid financing statement filings in accordance with the applicable state-adopted UCC.

On the other hand, because the Bankruptcy Code assesses enforceable security interests from the perspective of a third-party bona fide purchaser (instead of a two-party agreement), the creation and attachment of the franchisor’s security interest in the FF&E is insufficient to create a secured claim. Accordingly, the franchisee’s ability to identify vulnerabilities in the perfection or priority of the franchisor’s lien will shift the leverage landscape and likely reduce the franchisor’s payout. Perhaps more importantly, if a franchisee can avoid the secured nature of the franchisor’s claim, the franchisee no longer requires the franchisor’s consent for use of its claimed lien proceeds and, as a result, the franchisor’s level of influence over any plan of reorganization is substantially diminished.

III. Scenario Three: Franchisee Owns the Property

Although less common, sometimes the franchisee owns the property where it will operate the franchised business. Upon expiration or termination of the franchise agreement, the franchisor may want for a variety of reasons to purchase the franchised business and the real property from the franchisee. The franchise agreement should include an option to purchase provision allowing the franchisor to elect to purchase the franchised business and real property upon expiration or termination of the franchise. As with any agreement, the franchisor should be careful that any subsequent amendments to the franchise agreement do not conflict with or vitiate the purchase option. The purchase option also needs to clearly specify what the franchisor is and is not purchasing. The franchisor likely wants to purchase all assets and personal property used in the franchised business and/or all ownership interest in the franchisee entity. The franchisor will not want to purchase any cash on hand, short-term investments, and any items not meeting its standards. The franchisor will also not want to purchase any goodwill associated with the trademarks because this already belongs solely to the franchisor. The purchase option provision should also contemplate a due diligence period for the purchase of the real property.

49. Id.
50. The purchase option may also give the franchisor the right to just purchase the franchised business and then enter into a lease with its former franchisee. Negotiating the terms of the lease could prove challenging if the parties’ relationship is acrimonious. The franchisor will want to include language in the franchise agreement that touches upon some of the most important terms of any future lease, such as term and rental amount.
51. See Nicole Micklich, Who Owns the Goodwill in Franchise Relationships?, 18 FRANCHISE LAWYER 1 (Spring 2015).
The language of purchase option provisions and the valuation mechanisms vary widely. This type of provision usually (1) requires the franchisor to notify the franchisee within a certain period of time after expiration/termination of the franchise agreement of the franchisor’s election to exercise its option to purchase, and (2) contemplates that the value of the assets will be determined by appraisal. The franchise agreement may include certain requirements for the appraisers (e.g., experience conducting appraisals in the relevant industry and independence from all parties). The franchise agreement may also include certain items that should be considered in determining the value of the property (e.g., terms for lease renewal) and certain things that should not be included (e.g., goodwill or similar value associated with franchisor’s marks because these are already owned by franchisor).52

There are numerous possibilities for how the appraiser(s) is selected. For example, (1) the franchise agreement may require the parties agree upon one appraiser; (2) the franchisor may have sole discretion to select the appraiser; (3) the franchisor may provide a list of approved appraisers from which the franchisee may choose; or (4) the parties may each choose an appraiser who together select a third appraiser.

To enforce a purchase option, the franchisor may need to file a lawsuit requesting specific performance or other equitable relief. The courts routinely recognize the validity of purchase option agreements, particularly in the franchise context.53 In the bankruptcy context, § 363 provides an attractive vehicle for a sale of assets for both the franchisee and franchisor. Notably, § 363(f) provides that a sale can be made free and clear of liens under certain scenarios. If the debtor is in favor of a sale, the franchisor may be able to use the “free and clear” nature of a § 363 sale to not only purchase the real estate, but also to obtain the franchisee’s FF&E free of encumbrances.54 Section 363 sales typically occur during the early stages of the bankruptcy proceeding and can be effectuated on little notice, so it behooves the franchisor to engage bankruptcy counsel quickly to ensure it does not miss out on any such opportunity in the proceedings.

52. Id.
54. E.g., In re Takeout Taxi Holdings, Inc., 307 B.R. 525, 528 (Bankr. E.D. Va. 2004) (explaining that § 363(f) is a powerful right available to a trustee. It permits a trustee to maximize the recovery from an asset without being unduly entangled at an early stage of the proceedings in controversies concerning the existence, validity, and priority of liens and other interests in the property sought to be sold. It allows a trustee to quickly cut through the potential morass of such controversies, promptly sell the property for the best price available, and resolve those controversies at a later date).
If the franchise agreement is terminated for a financial default, it is also likely that the franchisee-owner is in default of any mortgage on the property. The franchisor’s right to purchase the property may conflict with the mortgagee’s right to foreclose the mortgage. In order to avoid these competing interests, the franchisor should determine if the franchisee has a mortgage on the property prior to entering into a franchise agreement. If the franchisee does have a mortgage, the franchisor can request that the mortgagee enter into a Subordination, Non-Disturbance and Attornment Agreement (SNDA). The SNDA will require that the mortgagee honor the franchise agreement and permit the franchisor to purchase the real property (if the franchisor elects to do so) if the franchisee is in default of the mortgage. The SNDA should state that the franchisee remains solely liable for the default under the mortgage, even after the franchisor takes over the franchise business. The SNDA usually must be recorded in the real estate records to preserve its effectiveness against third-party purchasers.

IV. Conclusion

As set forth herein, careful planning and drafting on the front end can have a significant impact on parties’ rights to real estate when the franchise relationship ends or when the franchisee files for bankruptcy. Whether there are adequate protections across all documents (the franchise agreement, lease, UCC filings, and security deeds) will determine who controls the location when the franchise relationship ends or is otherwise impacted by bankruptcy.

Walking the Line: When are the Franchisor’s In-House Counsel’s Communications or Advice to a Franchisee an Ethical Violation?

James Mulcahy and Douglas Luther

A wide assortment of rules and laws guide the franchisor counsel in deciding whether and how to communicate with and advise franchisees. The Model Rules of Professional Conduct set the guidelines for attorneys’ ethical obligations.1 The Model Rules are created by the American Bar Association and have been adopted in at least thirty-nine states.2 However, each state’s ethical rules may vary from the Model Rules.3 Notably, no separate rules exist for in-house counsel.

The franchisor’s in-house counsel’s client is the franchisor, which is typically a corporation or other business entity. The franchisor acts through its officers, directors, employees, and shareholders.4 Generally, an in-house counsel’s clients are any of the franchisor’s representatives with whom counsel works as long as they are pursuing the best interests of the entity.5 Because a franchisee is a separate legal entity and not an agent of the franchisor, a franchisee is not the in-house counsel’s client. How, then, is an in-house counsel to approach a franchisee? This article explores how the fran-

1. See generally MODEL RULES OF PROF’L CONDUCT (AM. BAR ASS’N 2015); Pam Jenoff, Going Native: Incentive, Identity, and the Inherent Ethical Problem of In-House Counsel, 114 W. Va. L. Rev. 725, 734 (2012).
2. Jenoff, supra note 1, at 734.
3. Counsel should review their state model rules and local bar opinions for additional clarity as to counsel’s ethical obligations.
5. Hackett, supra note 4, at 320–21.

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chisor counsel’s interactions with franchisees are guided by pertinent rules of professional conduct, ethical opinions, and caselaw.

Section I explores what sort of advice in-house counsel can provide franchisees. When is advice business or legal and what issues arise with providing legal advice? Section II explores some of the areas where counsel should tread carefully: where the franchisee seeks advice related to a third party, where litigation is anticipated or commenced, where the franchisor owes a fiduciary duty, and where the franchisor has engaged in fraudulent conduct. Section III explores how in-house counsel should approach franchisees represented by counsel. Section IV provides some parting advice for in-house counsel in deciding whether and how to communicate with franchisees.

I. Providing Advice to Franchisees

The role of the franchisor counsel often entails communicating directly with franchisees or the franchisees’ counsel. In both circumstances, counsel may find himself or herself asked to provide legal advice with regard to the franchise agreement or franchise relationship, including disclosure obligations, marketing plans, trademarks and trademark infringement, product pricing, restrictions on suppliers, rebates, restrictive covenants on employees, development agreements, territorial encroachment, non-renewal, transfers, termination, and constructive termination, among other issues.

A. Concerns with Providing Any Advice to a Franchisee

Although attorneys’ professional liability is typically limited to clients, an attorney is held to certain guidelines in communicating with non-clients. If the franchisor counsel violates a duty to the franchisee, assuming a duty has been established under the Model Rules or the Restatement (Third) of the Laws Governing Lawyers (or more likely state statutes reflecting those rules), the franchisor counsel could be held liable and/or face disciplinary action. Thus, counsel should take the following steps to ensure any advice comports with ethical guidelines.

1. Counsel Should Be Careful in Disclosing the Franchisor’s Confidential Information

Prior to giving advice, counsel must consider whether it regards confidential and material information. The Model Rules require that counsel not

6. Even represented franchisees may seek the advice of in-house counsel since many franchisees are represented by a generalist rather than an attorney knowledgeable in franchise law. See Robert W. Emerson, Fortune Favors the Franchisor: Survey and Analysis of the Franchisee’s Decision Whether to Hire Counsel, 51 SAN DIEGO L. REV. 709, 719 (2014).
7. Gregory M. Duhl, The Ethics of Contract Drafting, 14 LEWIS & CLARK L. REV. 989, 1017 (2010) (“Because attorneys generally do not have a fiduciary relationship with non-clients, the traditional rule is that they are only liable to third parties in cases of fraud or improper motive.”).
9. Emerson, supra note 6, at 741; RESTATEMENT (THIRD) OF AGENCY § 7.01 (2006).
reveal the franchisor’s confidential information without the franchisor’s consent. A franchisor’s in-house counsel will implicitly be able to reveal information or results of an evaluation based on counsel being an agent of the franchisor. However, where the information at issue is more material and sensitive, counsel should discuss the issue internally with the franchisor executives before communicating with the franchisee.

For example, the franchisor may create a development plan for a state specifying possible locations and anticipated opening dates. At the same time, the franchisor counsel may be communicating with a franchisee with regard to the franchisor’s development. Counsel should be careful not to reveal the development plan unless and until the development executives have approved it for disclosure. This is particularly important because the development plan may only be a draft and therefore not be a proper articulation of the franchisor’s development strategy.

2. Counsel Must Perform Due Diligence Prior to Communicating Facts or Law

The franchisor counsel needs to engage in whatever due diligence is necessary to have a reasonable basis for any advice given. Counsel can be liable to a franchisee (or any third party) for a “reckless as well as [a] knowing misrepresentation.” It will not necessarily suffice for the franchisor counsel to simply rely on the franchisor’s business agent’s representations, particularly if the franchisor counsel has not done so previously. Counsel, especially if in doubt as to the veracity of a fact, should seek independent or third party verification before communicating it to a franchisee.

3. When Communicating with a Franchisee, the Franchisor Counsel Should Make It Clear That Counsel Represents the Franchisor Only

Due to the close relationship between the franchisor and the franchisee, the franchisee may expect that the franchisor’s counsel has some sort of
duty to be fair to everybody rather than a duty of loyalty to the franchisor.\textsuperscript{16} The franchisee may view counsel as more of a go-between the parties than someone zealously advocating on behalf of a client, the franchisor. The franchisor counsel must take reasonable steps to clarify any confusion on the part of the third party as to the lawyer’s role.\textsuperscript{17}

Even where advice is more or less innocuous, it still may advantage the franchisor. It is rare that an attorney is not addressing an issue in a way that does not, at the very least, implicitly benefit the client.\textsuperscript{18} Thus, the franchisee should be reminded that counsel represents the franchisor and is acting for the franchisor’s benefit.\textsuperscript{19}

4. Counsel Must Not Make Any False Statements of Fact or a Fraudulent Omission to a Third Person

The franchisor counsel is obligated to be truthful in statements with others.\textsuperscript{20} “It is professional misconduct for a lawyer to . . . engage in conduct involving dishonesty, fraud, deceit or misrepresentation.”\textsuperscript{21} The Model Rules bar attorneys from making “a false statement of material fact or law to a third person.”\textsuperscript{22}

Nor can counsel make a material omission. Attorneys “shall not knowingly . . . fail to disclose a material fact when disclosure is necessary to avoid assisting a criminal or fraudulent act by a client.”\textsuperscript{23} This can include information that the lawyer had in mind but failed to disclose even though it was material\textsuperscript{24} to the issue at hand.\textsuperscript{25} Thus, a franchisor counsel must take the steps necessary to ensure that any advice (or communication) is accurate and that there are no material omissions. Otherwise, counsel and the franchisor may be liable.


\textsuperscript{18} Horton, \textit{supra} note 16, at 209–10.

\textsuperscript{19} The franchisor’s counsel’s duty of loyalty would arguably obligate counsel to communicate any material facts that redound to the benefit of the franchisor back to the franchisor. See, e.g., Horton, \textit{supra} note 16, at 210; Nancy J. Moore, \textit{Conflicts of Interest for In-House Counsel: Issues Emerging from the Expanding Role of the Attorney-Employee}, 39 \textit{S. Tex. L. Rev.} 497, 525 (1998) (“the individual should understand that there can be no expectation of confidentiality; all information given to the attorney will be shared with the company and vice versa”).


\textsuperscript{21} \textit{MODEL RULES OF PROF'L CONDUCT R. 8.4(c)}.

\textsuperscript{22} \textit{Id.} at R. 4.1.

\textsuperscript{23} \textit{Id.}

\textsuperscript{24} One definition of materiality that has been given is “information that ‘would or could significantly influence the hearer’s decision making process.’” \textit{In re Summer}, 105 P.3d 848, 853 (Or. 2005).

\textsuperscript{25} \textit{Id.}
General rules of law with regard to negligent misrepresentations and omissions are equally applicable to attorneys.26 For instance, the Restatement (Second) of Torts27 states that:

One, who, in the course of his business, profession or employment, or in any transaction in which he has a pecuniary interest, supplies false information for the guidance of others in their business transactions, is subject to liability for pecuniary loss caused to them by their justifiable reliance upon the information, if he fails to exercise reasonable care or competence in obtaining or communicating the information.

This section of the Restatement has been held to be applicable to attorneys.28 Furthermore, there is possible liability because of reliance. Franchisees, especially unrepresented ones, are likely to rely and act on a franchisor’s counsel’s statements. Thus, counsel is going to be held to a higher standard of communicating truthfully and accurately.29

Not all statements, however, constitute a misrepresentation. Counsel may generally give his or her opinion much as a salesperson would. “Certain statements, such as some statements relating to price or value, are considered nonactionable hyperbole or a reflection of the state of mind of the speaker and not misstatements of fact or law.”30 For example, counsel may tell a franchisee that he or she believes that the franchisee is well suited to expand because of the franchisee’s commitment to the brand and performance to date. Such comments would be nonactionable fraud.

Although it may be obvious that counsel may not make blatantly false statements, whether an omission or reaffirmation of a statement constitutes fraud can be a more complicated inquiry. For example, a Häagen Dazs franchisee alleged that a franchisor’s former president participated in an alleged fraudulent misrepresentations and omissions.31 The court held there was evidence that the former president swore to the truth of the franchisor’s offering circulars, which contained inaccurate start-up cost figures; that the former president may have participated in a conspiracy to supply misleading profitability information; and that the president knew of and approved of the alleged misrepresentations.

Under such a standard, the franchisee could similarly sue any attorney involved in similar communications for fraud. The case is also notable in that the officer was being held potentially liable on multiple grounds: both sup-

26. “[A] lawyer is subject to liability to a client or nonclient when a nonlawyer would be in similar circumstances.” RESTATEMENT (THIRD) OF THE LAW GOVERNING LAWYERS § 56 (2000).
30. RESTATEMENT (THIRD) OF THE LAW GOVERNING LAWYERS § 98 cmt. c.
31. Schwartz v. Pillsbury Inc., 969 F.2d 840, 843 (9th Cir. 1992); see also Am. Casual Dining, L.P. v. Moe’s Sw. Grill, L.L.C., 426 F. Supp. 2d 1356, 1365 (N.D. Ga. 2006) (court allowed claim to go forward where franchisee claimed that the franchisor negligently misrepresented the food and labor costs in running the restaurant franchise).
plying false information and reaffirming and approving a misrepresentation. For these reasons, when providing advice to franchisees, it is important to communicate accurately, clearly, and comprehensively, and use qualifiers when necessary.

B. *Continuum of Business to Legal Advice*

Whether a communication constitutes business or legal advice is a preliminary question in deciding whether the advice meets certain ethical guidelines. Some advice is purely business. For example, where counsel communicates that a location is ripe for a franchisee to open a new unit because of the demographics and retail mix. Some advice is purely legal. For example, where counsel communicates that the placement of a new unit does not violate the territorial provisions of the franchise agreement.

Communications, especially emails, often are in part business advice and in part legal advice. Typically, the portion of the communication that is legal versus the portion that is business can be distinguished. Advice becomes entirely legal when “the legal purpose so permeates any non-legal purpose that the two purposes cannot be discretely separated from the factual nexus as a whole.”

The issue comes up frequently when courts are adjudicating the attorney-client privilege. Those cases can provide a framework for understanding whether advice is business or legal for ethical rules purposes. *In re Human Tissue Products Liability Litigation* is illustrative. In that case, a corporation retained counsel for the purpose of conducting an investigation of facts and to make strategic recommendations with respect to the corporation’s business relationship with another corporation. The U.S. District Court for the District of New Jersey held that the documents relating to the lawyers’ tasks on that assignment pertained to business matters, rather than legal services, because: (1) “none of the documents appear to contain any legal research or analysis”; and (2) the work could have as easily been performed by non-lawyers.

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34. Counsel should also be aware of what advice is legal or business in determining whether internal communications are privileged. See William E. Matthews, et al., *Conflicting Loyalties Facing In-House Counsel: Ethical Care and Feeding of the Ravenous Multi-Headed Client*, 37 ST. MARY’S L.J. 901, 913–14 (2006).

35. In-house counsel should also be aware that where they are communicating internally about what business advice to provide the franchisee, their communications will likely not be privileged. See, e.g., United States v. Chevron Texaco Corp., 241 F. Supp. 2d 1065, 1076 (N.D. Cal. 2002) (“Corporations may not conduct their business affairs in private simply by staffing a transaction with attorneys.”).

The court’s decision necessitates an important point: if counsel is acting in a role and providing advice that could have been given by a non-lawyer (someone without legal expertise), the advice is likely to be business advice. In contrast, where the franchisor counsel provides legal analysis or research, it constitutes legal advice.\textsuperscript{37} For example, by the time a franchise comes up for renewal, the franchisor will very likely have revised its Franchise Disclosure Document (FDD). An attentive franchisee may ask the in-house counsel about those changes. The revisions to the FDD could be factual in nature, such as an Item 7 representation as to the estimated costs of opening a franchise. In-house counsel may explain that the revised costs were based on additional data reviewed in the past year. That is a business communication.\textsuperscript{38} If an Item 12 representation as to territory is changed because of a recently litigated encroachment case, the explanation of the change likely constitutes legal analysis. If counsel states that he or she believes that the revised language is consistent with a state’s law, counsel is providing a legal opinion.

C. Ethical Concerns Regarding Providing Legal Advice

The franchisor counsel is not prohibited from giving a franchisee, whether represented or not, legal advice.\textsuperscript{39} An older ABA Code of Professional Responsibility Disciplinary Rule 7-104 stated that an attorney shall not “[g]ive advice to a person who is not represented by a lawyer, other than the advice to secure counsel, if the interests of such person are or have a reasonable possibility of being in conflict with the interests of his client.” The later Model Rules dropped the prohibition on advice\textsuperscript{40} and instead merely restricted the giving of advice where the parties are adverse.\textsuperscript{41}

That being said, courts and ethics committees tend to closely scrutinize situations where an attorney provides legal advice to a non-client. As set forth later, if in-house counsel provides the franchisee with legal advice, it must be done with appropriate disclaimers and within a limited scope.

1. Stating the Franchisor’s Legal Position Is Not Providing Legal Advice

It is important to consider what is and is not legal advice. Providing legal documents, such as franchise disclosure documents, franchise agreements, and development agreements for signature, does not amount to advice.\textsuperscript{42} Further, if counsel is simply explaining the franchisor’s position, then the communications do not constitute providing legal advice.

\textsuperscript{39} Engler, supra note 17, at 84–85.
\textsuperscript{40} M O D E L R U L E S O F P R O F ’L C O N D U C T R. 4.3 (2015).
\textsuperscript{41} Id.
\textsuperscript{42} Engler, supra note 17, at 95.
The franchisor counsel may even communicate why counsel believes that the franchisor’s position is in congruence with the law without it being construed as legal advice.\textsuperscript{43} The Model Rules note that counsel may “explain the lawyer’s own view of the meaning of the document or the lawyer’s view of the underlying legal obligations.”\textsuperscript{44} For example, counsel could send a letter or email to a franchisee’s attorney noting the franchisor’s intent not to perform a term of the franchise agreement because of the legal analysis that it is not enforceable, and it would not be legal advice.\textsuperscript{45}

2. Counsel’s Legal Advice Cannot Conflict with the Duty of Loyalty

Counsel should not provide any legal advice to any non-client that conflicts with his or her obligations to the franchisor.\textsuperscript{46} It goes without saying that if the franchisor counsel is going to be giving the franchisee legal advice that has the potential to hurt or conflict with the franchisor’s interests, counsel should refrain from giving any such advice.

3. Counsel Should Give General Rather Than Specific Legal Advice

Counsel should keep any legal advice given to the franchisee of a general nature. The franchisor counsel should always remember that he or she is not the franchisee’s attorney. If the franchisee asks counsel to apply a certain law or the attorney’s knowledge to specific facts facing the franchisee, the franchisor counsel can advise that he or she is not here to offer specific legal advice.\textsuperscript{47} Counsel should refrain from advising the franchisee based on a fact-specific application of the law. Instead, counsel should tell the franchisee to seek independent counsel.

Similarly, the franchisor counsel is also better off not directing the franchisee as to a course of conduct. When counsel provides business or legal advice as applied to the franchisee’s situation, counsel can run into ethical troubles.\textsuperscript{48}

First, there is the risk, set forth in more detail in Section II.A, of creating an

\textsuperscript{43} That being said, counsel would potentially overstep into giving legal advice by referring to the strength of the franchisor’s legal position as opposed to the weakness of the franchisee’s legal position. See Engler, \textit{supra} note 17, at 95.

\textsuperscript{44} \textit{Model Rules of Prof’l Conduct} R. 4.3 cmt. 2.

\textsuperscript{45} \textit{Restatement (Third) of the Law Governing Lawyers} § 57 cmt. g (2000) (“As with other advisors to a contracting party, lawyers are protected against liability for interfering with contracts or with prospective contractual relations or business relationships . . . Thus a lawyer may ordinarily, without civil liability, advise a client not to enter a contract or to breach an existing contract. A lawyer may also assist such a breach, for example by sending a letter stating the client’s intention not to perform, or by negotiating and drafting a contract, with someone else that is inconsistent with the client’s other contractual obligations.”).

\textsuperscript{46} \textit{Model Rules of Prof’l Conduct} R. 1.7, 4.3; Martyn, \textit{supra} note 12, at 928.

\textsuperscript{47} Martyn, \textit{supra} note 12, at 923–27.

\textsuperscript{48} “In one of its earlier formal opinions, arising in the divorce context, the ABA held that an attorney may not give an unrepresented party ‘legal advice’ in an attempt to secure the latter’s consent to a course of action; the proper course for the attorney would be to tell the adverse party of the proposed action and recommend that he or she consult independent counsel.” Engler, \textit{supra} note 17, at 85–86, 97; ABA Comm. on Ethics and Prof’l Responsibility, Informal Op. 1034 (1968); ABA Comm. on Prof’l Ethics and Grievances, Formal Op. 58 (1931).
inadvertent attorney-client relationship. Second, giving advice as to a course of action is more likely to have negative ramifications if for any reason the advice does not lead to a good result and the franchisee sues. In such a circumstance, counsel should consider discussing the issue with the franchisor’s business agents and having them communicate it to the franchisee.49

4. Franchisor Counsel May Be Liable for Providing Wrong Legal Advice

One of the largest concerns with providing legal advice is that it may result in liability. If the legal advice provided by the franchisor’s attorney is not accurate, and the franchisee relies on it, the franchisor could be liable for the actions the franchisee takes based on the inaccurate information.50 This may lead to a claim against the franchisor and/or the attorney.

Franchisor counsel should be aware that providing legal advice outside of the litigation context can subject counsel to liability. By contrast, in litigation, attorneys and parties are protected by the “litigation privilege” in exercising their legal rights and setting forth legal opinions when communicating with opposing counsel and/or parties.51

When giving legal advice that a franchisee is relying on, counsel will generally owe a duty of care to the franchisee.52 The Restatement of the Law Governing Lawyers concludes that a lawyer owes a duty to use care to a non-client where (1) the lawyer’s client invites the non-client to rely on the lawyer’s opinion; (2) the non-client so relies; and (3) the non-client is not too remote from the lawyer to be entitled to protection.53

Whether a franchisee relies on a statement of the law may depend on the setting in which the advice was given (both when and where). Statements in a formal office setting carry more weight than general advice given at a conference or lunch.54 When the franchisee is given advice significantly before engaging in a course of action, the franchisee will have time to ask other parties, including lawyers, whether they agree with the advice. In contrast, counsel’s advice is likely to have a greater impact on a franchisee if made in the middle of a negotiation or at the time of signing a document.55

Liability is particularly an issue with FDDs drafted by in-house counsel. Franchisees occasionally attempt to sue the franchisor’s counsel, in addition to the franchisor, for any alleged misleading statements or omissions in the

49. It is important to note that counsel still has a duty of care to ensure that the franchisor’s business agents communicate accurately. See George J. Ziser, et al., Lawyer Liability to Non-Clients under the New Restatement of Law Governing Lawyers, 65 DEF. COUNS. J. 361, 363–65 (1998).
51. Ellis, supra note 15, at 19.
54. Engler, supra note 17, at 100.
55. Id.
At least one court has held that a misrepresentation in the franchisor’s offering circular was grounds for a claim of negligence against the franchisor’s counsel.57

There is an expectation by franchisees and franchise practitioners that the franchisor counsel should be properly advising the franchisee.58 Their basis is that this would result in full disclosure and the franchisee being better informed. The franchisor’s counsel is, in fact, more knowledgeable about the franchise system and applicable laws and thus can be a resource to franchisees. Others dispute this, arguing that courts should encourage potential franchisees to undertake their own due diligence and seek their own expert advice.59

Counsel should be aware that where the franchisee seeks legal advice, and counsel does not respond, franchisee’s counsel may in any subsequent litigation claim that the franchisor’s counsel concealed important information and kept the franchisee in the dark. However, if the franchisor’s counsel does provide information and it is inaccurate, then counsel and the franchisor face a potential fraud claim.60

Ultimately, the franchisor counsel should generally err on the side of not providing legal advice to franchisees and encouraging franchisees to consult independent attorneys. However, if the advice is accurate, generalized, and not specific to the franchisee, a franchisor’s counsel’s legal advice to the franchisee could potentially redound to both parties’ benefit.

II. Problem Areas for In-House Counsel

A. Where the Franchisee Seeks Advice Relating to a Third Party

Franchisees may seek the franchisor counsel’s advice with regard to third parties. For example, a franchisee may have a legal issue regarding the renewal of a lease and seek the franchisor’s advice on how to handle it. Maybe the franchisee asks the franchisor counsel how to interpret the lease agreement. Franchisor counsel must be very wary about getting involved in such a situation.

By giving advice to the franchisee, particularly with regard to third parties, the franchisor counsel risks creating an inadvertent attorney-client relationship. If the franchisee asks the franchisor counsel to provide legal services (e.g., advice) and the franchisor counsel consents without adequate disclosure, an attorney-client relationship may be formed.61 Notably, a franchisee can as-
sert an attorney-client relationship regardless of whether franchisor counsel intended one. A court would consider the franchisee’s reasonable expectations and if the franchisee was right to rely on the attorney’s opinion.

To alleviate this risk, the franchisor counsel should clarify that he or she is not the franchisee’s attorney and that any advice is not intended to create an attorney-client relationship. This clarification should preferably be in writing. Doing so will provide evidence that any advice was limited in scope and did not create an attorney-client relationship.

B. Where the Franchisor Owes a Fiduciary Duty to the Franchisee

Should in-house counsel approach a franchisee differently in states where the franchisor owes the franchisee a fiduciary duty? In most states, the franchisor does not owe the franchisee a fiduciary duty. A minority of states hold otherwise, concluding that either a fiduciary duty exists as a matter of law or that it may be established by the facts.

Where the franchisor owes the franchisee a fiduciary duty, it does not mean that the franchisor counsel owes the franchisee a fiduciary duty. An in-house counsel owes a fiduciary duty only to its client, in this case, the franchisor. However, the franchisor counsel may be liable in some states for aiding and abetting a breach of fiduciary duty. Claims alleging that an attorney aided and abetted a client’s breach of fiduciary duty are becoming more common. As of 2017, some twenty-three states allow for such a claim. These include the following states where courts have held the franchisor may owe the franchisee a fiduciary duty: New York, Ohio, Oregon and South Dakota.

Aiding and abetting claims have been brought against attorneys where the attorney acts outside of the scope of representation. This includes actions taken beyond the agreement of the two parties, actions without

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63. Id.; see also RESTATEMENT (THIRD) OF THE LAW GOVERNING LAWYERS §§ 26, 51 (2000); Moore, supra note 19, at 501–02.
64. Ellis, supra note 15, at 20–21.
66. States where courts have applied a fiduciary duty to franchisor-franchisee relationships include Maine, Mississippi, Missouri, New York, North Carolina, Ohio, Oregon, South Dakota, and Utah. Id.
67. Emerson, supra note 6, at 740.
68. RESTATEMENT (THIRD) OF AGENCY § 8.01 (2006) (“An agent has a fiduciary duty to act loyally for the principal’s benefit in all matters connected with the agency relationship”); see also RESTATEMENT (THIRD) OF THE LAW GOVERNING LAWYERS § 16, cmt. b.
70. Id. at 160; see also RESTATEMENT (THIRD) OF THE LAW GOVERNING LAWYERS § 56, cmt. h (“[I]lawyers are also liable to nonclients for knowingly participating in their client’s breach of fiduciary duties owed by clients to nonclients”); Schiltz, supra note 50, at 81-82.
71. Lewinbuk, supra note 69, at 160-61.
72. Compare Killon, supra note 65, with Lewinbuk, supra note 69, at 160–61.
73. Lewinbuk, supra note 69, at 165–67.
prior written consent from an employer, or actions that aid a client’s unlawful act.

Where a fiduciary duty exists, the franchisor may have higher expectations with regard to disclosing material information regarding the franchise, or there may be heightened obligations as to self-dealing, encroachment, and termination, among other issues. Furthermore, a franchisee may be owed greater care in being dealt with “fairly,” particularly with regard to discretionary provisions or implied terms in the franchise agreement. Thus, counsel should be aware of the potentially expanded obligation for disclosure when communicating or advising franchisees in fiduciary duty states.

C. Role Where the Parties Interests Conflict

Where franchisor counsel knows or reasonably should know that the interests of the franchisee are in conflict with or adverse to the franchisor, counsel should not give legal advice. Note, however, that this does not prohibit counsel from negotiating with the franchisee or settling a dispute. Thus, counsel may still communicate with the franchisee under the guidelines established above. However, counsel must be careful not to provide legal advice.

For example, in one case, Safeguard distributors had account protection rights. The distributors understood their agreement to give them the right to all commissions on sales to accounts to which they had been the first to make a sale. The franchisor, who had brought two company-owned distributors into the market, disputed this and surreptitiously allowed the company-owned distributors to sell to the other distributors’ protected accounts. When the unrepresented distributors heard of the infringing sales, they contacted Safeguard’s general counsel, who met with one of them. When the distributor asked whether she should consult an independent attorney, Safeguard’s general counsel told the distributor “no” and that the conversation they would have was business related. The Safeguard general counsel proceeded to advise the distributor, who had adverse interests, that the distributor was not entitled to commissions on company-owned distributor’s sales and then falsely claimed he did not have the sales information. The court pointed to the conversation as one of the grounds for allowing the distributors to pursue punitive damages. The court noted that there was evidence that the general counsel had acted fraudulently and in an extreme deviation from reasonable standards of conduct.

74. Id. at 167.
75. Id. at 165.
76. See, e.g., Arnott v. Am. Oil Co., 609 F.2d 873, 880-81 (8th Cir. 1979).
77. MODEL RULES OF PROF’L CONDUCT R. 4.3 (2015); Horton, supra note 16, at 208-09; Moore, supra note 19, at 504.
78. MODEL RULES OF PROF’L CONDUCT R. 4.3 cmt. 2.
D. Situations Where the Franchisor Has Engaged in Fraudulent or Illegal Conduct

If the franchisor counsel suspects that a representative of the franchisor has engaged in fraudulent or illegal conduct toward a franchisee, counsel must tread carefully with providing advice or responding to a franchisee’s related inquiries. In determining how to respond to such conduct by a franchisor’s agent, counsel should consider the seriousness of the violation and its consequences.80

The franchisor counsel owes his or her client duties of loyalty and confidentiality. As set forth by the Model Rules, “[w]hen constituents of the organization make decisions for it, the decisions ordinarily must be accepted by the lawyer even if their utility or prudence is doubtful. Decisions concerning policy and operations, including ones entailing serious risk, are not as such in the lawyer’s province.”81

However, where an agent’s actions threaten to substantially injure the franchisor, counsel must “proceed as is reasonably necessary in the best interest of the organization.”82 The franchisor counsel can attempt to remedy the conduct internally.83 Barring that, counsel is responsible for reporting up to the highest authority for the franchisor, potentially up to the board of directors, depending on the seriousness of the violation, in order to prevent harm to the franchisor’s interests.84 Counsel’s primary objective is to assist the franchisor even if the franchisor’s objectives are inconsistent with the goals and objectives of some of its representatives, including chief level officers.85

Outwardly, counsel must ensure that their actions do not aid or abet fraudulent or illegal conduct. Counsel must weigh their duty of loyalty and zealous advocacy to their client against the duty of candor toward third parties.86 This can be a tough balancing act. An attorney is ethically required to keep a client’s secrets and generally cannot communicate any wrongdoing uncovered.87 However, counsel cannot assist a client in perpetrating a crime or fraud and may be liable if they do so, even if acting on behalf of the franchisor.88

80. MODEL RULES OF PROF’L CONDUCT R. 1.13 cmt. 4.
81. Id. at R. 1.13 cmt. 3.
82. Id. at R. 1.13 cmt. 4.
83. Id.
84. Id. at R. 1.13 cmt. 5; Kim, supra note 4, at 181.
85. Kim, supra note 4, at 191.
86. MODEL RULES OF PROF’L CONDUCT R. 4.1; Randolph C. Park, Ethical Challenges: The Dual Role of Attorney-Employee As Inside Corporate Counsel, 22 HAMLINE L. REV. 783, 784 (1999).
87. MODEL RULES OF PROF’L CONDUCT R. 1.13 cmt. 2 (“When one of the constituents of an organizational client communicates with the organization’s lawyer in that person’s organizational capacity, the communication is protected by Rule 1.6. Thus, by way of example, if any organizational client requests its lawyer to investigate allegations of wrongdoing, interviews made in the course of that investigation between the lawyer and the client’s employees or other constituents are covered by Rule 1.6.”).
88. Id. at R. 1.2(d); Park, supra note 86, at 783; RESTATEMENT (THIRD) OF AGENCY § 7.01 (2006) (agent liable for commissions of tortious fraud even when acting on behalf of principal).
In limited situations, the franchisor counsel may be permitted to reveal confidences to remedy a fraudulent representation or omission. The Model Rules authorize lawyers to disclose even confidential information to prevent “the client from committing a crime or fraud that is reasonably certain to result in substantial injury to the financial interests or property of another.” Counsel can make the disclosure before the fraud has even occurred, if disclosure might prevent the injury to the franchisee.

For example, say a franchisor represents in its Franchise Disclosure Document that ninety percent of the marketing fund goes to actual advertising and ten percent goes to administrative costs (e.g., salaries of employees). The representation is false because the executives are using ninety percent of the marketing fund for their own benefit, such as bonuses and lavish trips. If the franchisor counsel finds out about the misrepresentation, he or she must counsel the client to disclose the actual numbers.

Failing that, counsel may consider taking the matter into his or her own hands, disclosing the actual numbers to the franchisee. Under the Model Rules, counsel is permitted, although not obligated, to disclose such information to ensure that he or she is not assisting the client in conduct known to be fraudulent. This does not mean that counsel should tell the franchisee that fraud was committed (e.g., provide fact-specific legal advice). Instead, counsel could state that there was an error and that the actual numbers show that ninety percent of the marketing fund goes to administrative expenses. Alternatively, counsel may withdraw from representation by leaving the franchisor counsel role. If the situation is bad enough, counsel may even consider both withdrawing and disclosing the issue to the franchisee.

In most instances, the wiser course of conduct is to refrain from communications with the franchisee, unless absolutely necessary to ensure that counsel is not perpetuating a fraud. The communication should not come until counsel has made an effort to resolve the matter internally. The corrected disclosures or representations should come from the franchisor’s business agents. If counsel does respond to franchisee inquiries, the communication must be carefully crafted to ensure that it either rectifies the misrepresentation or otherwise does not continue it or omits material information.

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89. Model Rules of Prof’l Conduct R. 4.1 (barring lawyers from “fail[ing] to disclose a material fact to a third person when disclosure is necessary to avoid assisting a criminal or fraudulent act by a client”).
90. Id. at R. 1.6(b)(2).
91. Id. at R. 1.6(b)(3).
92. Duhl, supra note 7, at 999.
93. Model Rules of Prof’l Conduct R. 1.6(b)(6) (2015) (permissive exception “to the extent the lawyer reasonably believes necessary . . . to comply with other law or a court order.”); id. at R. 1.2(d) (lawyer’s obligation not to assist the client in known fraudulent conduct).
94. Id. at R. 1.16(b) (“[A] lawyer may withdraw from representing a client if . . . the client persists in a course of action involving the lawyer’s services that the lawyer reasonably believes is criminal or fraudulent.”).
95. Duhl, supra note 7, at 1000.
III. Communicating with Represented Franchisees

Franchisees, especially single-unit franchisees, typically are not represented by counsel, either at the commencement of the franchise relationship or during its duration. One study showed that in negotiating a franchise agreement, only twenty-six percent of franchisees had counsel represent them. However, larger franchisees may have an in-house attorney of their own. And smaller franchisees may utilize an attorney in specific circumstances, such as when signing the franchise agreement, where there are relationship troubles, or where the parties are disputing a termination of the relationship. When a franchisee is represented, the franchisor counsel should follow certain guidelines in communicating with the franchisee.

When a franchisee is or may be represented on an issue (or generally), the franchisor counsel should direct his or her communications to the franchisee’s attorney. The franchisor counsel may not communicate about the subject of the representation directly with the franchisee. The same rule applies even if the franchisee initiates a communication with the franchisor counsel. An attorney’s representation of the franchisee on a single issue (e.g., signing the franchise agreement) does not preclude the franchisor counsel from later communicating directly with the franchisee. However, if the attorney represents the franchisee as to all issues, all communications must go from counsel to counsel.

Many of the same rules discussed in Sections I and II apply where the franchisee is represented. One important distinction, however, is that the franchisor counsel has greater latitude in providing specific legal advice. For example, the franchisor counsel could give a legal opinion that a new location does not encroach on a franchisee (e.g., violate the terms of the franchise agreement) and that the franchisee has no valid legal claim as to a breach of the franchise agreement. Further, the franchisor counsel can now advise the franchisee as to a course of conduct without the concern of inadvertently creating an attorney-client relationship. Thus, the franchisor counsel can advise the franchisee to take specific actions (e.g., “don’t file a claim because it has no legal merit”).

What if the franchisee’s counsel is not providing effective legal representation and giving bad advice to the franchisee? This can arise in situations where a generalist attorney rather than a franchise practitioner is representing the franchisee. In that situation, the franchisor counsel generally does not have an obligation to remedy the ineffective representation or to suggest that a franchisee seek different counsel.

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96. Emerson, supra note 6, at 718.
98. Id. at R. 4.2 cmt. 3.
99. Id. at R. 4.2.
However, the franchisor counsel cannot take “unfair advantage” of a mistake made by the franchisee’s counsel. For example, in an ABA Informal Ethics Opinion,\(^{101}\) the hypothetical is posed wherein the lawyer for party A discovers that the lawyer for party B inadvertently omitted a material provision of an agreement between the parties, a provision without which party B would not have agreed to the contract. The opinion advises that the lawyer for party A has an obligation to correct the error and not to allow his or her client to take unfair advantage of the mistake.\(^{102}\)

Further, when negotiating with the franchisee counsel, the franchisor counsel must be forthright on proposed changes to any document at issue (e.g., the franchise agreement, development agreement, settlement agreement). For example, in such negotiations, it may be considered a “false statement of material fact” not to disclose last minute alterations to the document at issue.\(^{103}\) Thus, the franchisor counsel may not mislead the franchisee counsel into missing a key detail.

To the extent that the franchisor counsel does not want to deal with the franchisee’s counsel, any communications would have to go through the business agents. Where both parties are represented, the franchisor’s business agents can still reach out to the franchisee directly.\(^{104}\) In such a situation, the franchisor counsel can advise the franchisor’s business agents about the subject matter of the communication, although scripting the communication has been considered over the line.\(^{105}\)

**IV. How In-House Counsel Should Approach Communications with Franchisees**

In-house counsel would be well served to consider (1) whether the franchisee is represented by counsel; and (2) the nature of the communication or advice to be given to a franchisee. The best way to avoid liability is to make sure any representations or advice are accurate and not misleading. Counsel should undertake the due diligence necessary to have a reasonable basis for any advice or communication.

Counsel should set and enforce clear boundaries with franchisees. Franchisees need to know that the franchisor counsel is not a disinterested party, represents the interests of the franchisor, and is not the franchisee’s attorney. If the parties are adverse on an issue, counsel should recommend that the franchisee seek independent legal counsel.

The franchisor counsel may give the franchisor’s legal position and understanding of its obligations. Where a franchisee is represented, counsel

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102. Duhl, supra note 7, at 1001–03.
103. Id. at 1006–07; Model Rules of Prof’l Conduct R. 4.1(a).
104. Model Rules of Prof’l Conduct R. 4.2 cmt. 4.
can provide legal advice or opinions as to the merits of the franchisee’s position. However, unrepresented franchisees should generally not be given legal advice specific to their situation. And counsel should take care in providing advice outside of the litigation context because such communications are not protected.

By following these guidelines, the franchisor counsel can have a productive and beneficial relationship with franchisees.
A hallmark feature of any franchise system is uniformity, which begins with the franchise agreement and is supported by a system’s operations manual. The franchise agreement sets forth the contractual rights and obligations of both the franchisee and the franchisor, and one of the franchisee’s contractual obligations is to comply with the franchisor’s standards, as described in the franchisor’s operations manual. The existence of, and compliance with, the standards drives the uniformity that franchisors and franchisees seek.

Therefore, at a macro-level, inconsistent enforcement of franchise agreement terms by franchisors seems to fly in the face of the goal of having a uniform system. Nonetheless, franchisors are often faced with the decision of whether or not to enforce the terms of the franchise agreement or enforce the standards consistently across all franchisees.

Often, these decisions are difficult determinations made after extensive review of the facts at hand, and franchisors are all too aware of the potential claims a franchisee can make in rebuttal. However, for a variety of reasons—business, legal, or otherwise—franchisors often choose not to uniformly enforce the agreement or compliance with the standards. Regardless of the reason behind a franchisor’s inconsistent enforcement practices, such practices expose franchisors to claims of discriminatory treatment related to enforcement of the franchise agreement. This article reviews the statutory and common law bases for these types of claims.
I. State Anti-Discrimination Statutes

Six states—Arkansas, Hawaii, Illinois, Indiana, Washington, and Wisconsin—have enacted franchise relationship laws with anti-discrimination components. These statutes provide a statutory basis for a franchisee to object to the selective enforcement of a franchise agreement based on discrimination.

A. Arkansas

There are two anti-discrimination components to the Arkansas Franchise Practice Act (AFPA). First, the AFPA prohibits a franchisor from terminating or non-renewing a franchise agreement without good cause. The AFPA’s definition of “good cause” includes “[f]ailure by a franchisee to comply substantially with the requirements imposed upon him or her by the franchisor, or sought to be imposed by the franchisor, which requirements are not discriminatory as compared with the requirements imposed on other similarly situated franchisees, either by their terms or in the manner of their enforcement . . .” The statute does not further define or provide factors relating to “similarly situated,” providing franchisors with an argument that supports their decision to enforce the franchise agreement differently for different franchisees, depending on the facts of the situation at the time.

Second, the AFPA prohibits a franchisor from refusing “to deal with a franchise in a commercially reasonable manner and in good faith.” While the Arkansas statute does not provide a definition for “commercially reasonable manner,” it does define “good faith” as “honesty in fact in the conduct or transaction concerned.”

In order to establish a breach of the good faith obligation, a plaintiff must establish that the defendant was not honest in fact and acted with a bad motive. For example, the Arkansas Supreme Court held in Miller Brewing Co. v. Ed Roleson, Jr., Inc. “that a franchisor’s attempt to force a franchisee out of business may constitute a refusal to deal with a franchise in a commercially reasonable manner and in good faith under [the AFPA].”

B. Hawaii

The Hawaii Franchise Investment Law specifically requires the franchisor and franchisee to “deal with each other in good faith.” It expressly prohibits franchisors from discriminating between franchisees:

2. Id. § 204.
3. Id. § 202(7)(A).
4. Id. § 206(6).
5. Id. § 202(8).
7. 223 S.W.3d 806, 812 (Ark. 2006).
9. Id. § 482E-6(1).
in the charges offered or made for royalties, goods, services, equipment, rentals, advertising services, or any other business dealing, unless and to the extent that any classification of or discrimination between franchisees is:

(i) Based on franchises granted at materially different times, and such discrimination is reasonably related to such differences in time;

(ii) Is related to one or more programs for making franchises available to persons with insufficient capital, training, business experience, education or lacking other qualifications;

(iii) Is related to local or regional experimentation with or variations in product or service lines or business formats or designs;

(iv) Is related to efforts by one or more franchisees to cure deficiencies in the operation of franchise businesses or defaults in franchise agreements; or

(v) Is based on other reasonable distinctions considering the purposes of this chapter and is not arbitrary. 10

C. Illinois

The Illinois Franchise Disclosure Act functions much like an antitrust statute and is limited in scope. First, the anti-discrimination portions of the statute apply only to the potentially disparate treatment of franchisees that operate businesses within the state of Illinois. 11 Second, the statute prohibits a franchisor from “unreasonably and materially” discriminating between Illinois franchisees in terms of franchise fees, royalties, goods, services, equipment, rentals, or advertising services if “such discrimination will cause competitive harm to a franchisee who competes with a franchisee that received the benefit of the discrimination.” 12 The statute excludes certain types of discrimination between franchisees, including discrimination that (1) is reasonably related to franchises granted at different times; (2) is related to programs that make franchisees available to individuals with “insufficient capital, training business experience or education, or lacking other qualifications;” (3) is related to regional testing of various offerings; (4) is related to efforts by franchisees to cure franchise agreement defaults or operational deficiencies; and (5) is based on reasonable but not arbitrary distinctions between the franchisees. 13

In P&W Supply Co. v. E.I. DuPont de Nemours & Co., the U.S. District Court for the Northern District of Illinois provided examples of the types of acts that would constitute discrimination under this statute. 14 It discussed a scenario where a fast food franchisor supplied hamburger meat to one franchisee at 30 cents a pound, while selling meat to another franchisee for 60 cents a pound. 15 It also provided another example of prohibited conduct,
explaining that a franchisor cannot require one franchisee to sell a hamburger for $2.00 while it allows a competing franchisee to sell a hamburger for $1.00. In this case, the court also refused to expand the scope of the anti-discrimination statute where the plaintiff did not allege any form of price discrimination as provided in the statute, stating “the Court must give the words in the statute their plain and ordinary meaning and cannot stretch to find provisions that are not there.”

D. Indiana

The Indiana Deceptive Franchise Practices Act (IDFPA) offers franchisees broad protection against discrimination, making Indiana an appealing state for franchisee discrimination claims against franchisors. Under the IDFPA, it is unlawful for a franchisor who is a party to a franchise agreement with a franchisee who is a resident of Indiana or operating a business in Indiana to “discriminat[e] unfairly among its franchisees or unreasonably fail[ ] or refus[e] to comply with any terms of a franchise agreement.” This provision is the most litigated provision of the IDFPA, but it is a difficult standard for franchisees to meet.

In Canada Dry Corp. v. Nebi Beverage Co., Inc., the court established that to prevail on a discrimination claim against a franchisor under the IDFPA, a franchisee must demonstrate that “between two or more similarly situated franchisees, and under similar financial and marketing conditions, a franchisor engaged in less favorable treatment toward the discriminatee than toward the other franchisee.” The court looked to other types of discrimination doctrines for this analysis, specifically employment and freight rate discrimination, and focused on the “similarity of situation” between the franchisees at issue. The court held that “absent an adequate showing of comparability between the alleged deficiencies of Nehi and the deficiencies of other bottlers, it was error to submit Nehi’s claim under IND. CODE § 23-2-2.7-2(5) to the jury.” Of more benefit to franchisors, the court noted, “a demonstration of comparability in a termination context will no doubt be difficult, but we think this is no reason for sustaining discrimination claims where there is an inadequate basis of comparison.”

In Carrel v. George Weston Bakeries Distribution, Inc., a franchisee brought a discrimination claim under the IDFPA against the franchisor based on claims that the franchisor paid selective grants of higher commissions to cer-

16. Id.
17. Id.
18. Id.
20. Id.
21. 723 F.2d 512, 521 (7th Cir. 1983).
22. Id. at 521.
23. Id. at 522.
24. Id.
tain franchisees compared to other franchisees when the franchisor implemented a plan to “weed out” franchisees it considered to be “under achievers.” The franchisor moved for summary judgment on the discrimination claim, maintaining that the plaintiff failed to “present any facts regarding the similarity of the marketing conditions between distributors and that any alleged discrimination by [franchisor] was arbitrary and unfair.” The court denied the franchisor’s motion for summary judgment because there was some “commonality of routes, agreements, and marketing plans.”

In Andy Mohr Truck Center, Inc. v. Volvo Trucks North America, the court clarified that in determining whether franchisees are similarly situated, “precise equivalence is not required . . . [s]o long as the distinctions between the plaintiff and the proposed comparators are not ‘so significant that they render the comparison effectively useless.’” Here, the court found that the dealer presented sufficient evidence to establish that the similarly situated requirement was satisfied when the franchisee presented evidence that: the dealers operated under the same marketing and sales policies; there were comparable transactions for the same truck model; the market for large fleet accounts was national; and the dealers had almost identical dealer agreements.

The court also elaborated on “what it takes to ‘discriminate unfairly’ under the IDFPA.” The IDFPA places the burden on the plaintiff to demonstrate that any differences in a franchisor’s treatment of franchisees amount to unfair discrimination. Here, the dealer agreement specified that dealers would participate in the Retail Sales Assistance (RSA) program, through which dealers submit requests for additional discounts off the net price based on deal-specific details. In the RSA, the franchisor preserved its discretion to grant different discounts for each transaction, with the exception that it would extend the same discount to any dealers bidding on the same purchase for the same customer. The court provided in dicta examples of what might constitute discrimination under the IDFPA—a franchisor consistently awarding lower discounts to competitors or offering less favorable terms for the same purchase by the same customer. However, the court rejected the premise that thirteen transactions where the franchisor offered inferior concessions to a dealer than it offered other comparable dealers established unfair discrimination.

26. Id. at *26.
27. Id.
28. 869 F.3d 598, 604 (7th Cir. 2017) (quoting Coleman v. Donahoe, 667 F.3d 835, 846–47 (7th Cir. 2012)).
29. Id. at 607.
30. Id. at 605.
31. Id. at 606.
32. Id.
33. Id. at 607.
34. Id.
E. Washington

The Washington Franchise Investment Protection Act (WFIPA) tracks closely with the Hawaii Franchise Investment Law. Franchisor and franchisee must deal with each other in good faith. Additionally, a franchisor exposes itself to claims of unfair or deceptive practices if it:

> [d]iscriminate[s] between franchisees in the charges offered or made for royalties, goods, services, equipment, rentals, advertising services, or in any other business dealing, unless and to the extent that the franchisor satisfies the burden of proving that any classification of or discrimination between franchisees is: (i) Reasonable, (ii) based on franchises granted at materially different times and such discrimination is reasonably related to such difference in time, or is based on other proper and justifiable distinctions considering the purposes of this chapter, and (iii) is not arbitrary.

As demonstrated in Armstrong v. Taco Time International, Inc., if franchisors comply with the statute, they have leeway in how they enforce the terms of the franchise agreement. Armstrong entered into an agreement with Taco Time in order to have the exclusive right to operate Taco Time restaurants in a 50-mile radius. The agreement contained an in-term and five-year post-term noncompetition provision. Armstrong opened competing businesses within the 50-mile radius and within the protected area of other Taco Time franchisees and then sued to invalidate the noncompetition covenant. The trial court upheld the in-term noncompetition covenant but modified the post-term covenant.

Armstrong appealed and argued that enforcement of the noncompetition covenants violated the nondiscriminatory provisions of WFIPA. The Washington Court of Appeals rejected Armstrong’s argument and affirmed the trial court’s decision. The appeals court not only found that the modified covenant was not discriminatory, but also affirmed that the statute allows for discrimination if the franchisor shows the discrimination is “(1) ‘reasonable,’ (2) ‘based on franchises granted at materially different times’ and is ‘reasonably related to such difference in times’ or based ‘on other proper and justifiable distinctions considering the purposes’ of the Franchise Act, and (3) ‘not arbitrary.’”

F. Wisconsin

Under the Wisconsin Fair Dealership Law (WFDL), a franchisor cannot terminate, cancel, or fail to renew a franchise agreement without good cause;

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35. WASH. REV. CODE ANN. § 19.100.180(1).
36. Id. § 19.100.180(2)(c).
38. Id. at 1116.
39. Id.
40. Id.
41. Id. at 1120.
42. Id.; see also Saleemi v. Doctors Assocs., Inc., 292 P.3d 108, 111 (Wash. 2013) (finding that Doctors Associates, Inc. discriminated between franchisees that were similarly situated because DAI did not prove the discrimination was reasonably necessary).
the burden of proving good cause is on the franchisor. 43 “Good cause” is defined as a failure by the franchisee to substantially comply with the essential and reasonable requirements imposed by the franchisor, or sought to be imposed by the franchisor, which requirements cannot be discriminatory as compared with requirements imposed on other similarly situated franchisees either by their terms or in the manner of their enforcement. 44

If a franchisor violates the WFDL, the statute specifically grants franchisees the right to seek damages, attorney fees, and related costs and to seek injunctive relief against a franchisor’s unlawful termination or nonrenewal of a franchise agreement. 45

In American Dairy Queen Corp. v. Universal Investment Corp., American Dairy Queen Corporation (ADQ) sought a declaratory judgment that it properly terminated the franchise agreement with Universal Investment Corporation under the provisions of the WFDL. 46 Universal asserted counterclaims, including violation of the WDFL. 47 In September 2017, prior to the scheduled trial date, the parties filed multiple motions in limine. 48 The court’s opinion relating to ADQ’s motion to exclude evidence relating to other Dairy Queen franchisees should make franchisors take notice. In its motion, ADQ predicted that Universal was going to attempt to introduce evidence showing that five other franchisees and approximately 40 other Dairy Queen stores were not in compliance with ADQ’s brand standards and introduce testimony from other franchisees and employees who provide support to other franchisees. 49 ADQ argued that Universal’s evidence was not relevant to the WFDL counterclaims, arguing the other franchisees were not “similarly situated” for purposes of determining whether the termination was non-discriminatory because: (1) the levels of non-compliance among the various franchisees are not the same; (2) the franchise agreements with the various franchisees and ADQ are not the same; and (3) some of the franchisees are not located in Wisconsin. 50

Universal argued that whether or not the evidence was admissible for purposes of arguing discrimination, it was material in determining if the “essential and reasonable” elements contained in the statute’s definition of “good cause” were met. 51

The court agreed with Universal that evidence that ADQ tolerates varying degrees of compliance with its requirements may bear upon whether the

44. Id. § 135.02(4)(a).
45. Id. § 135.06.
47. Id.
49. Id. at *2.
50. Id. at *2–3.
51. Id. at *3.
requirement is truly reasonable and essential. The court further determined that ADQ’s definition of “similarly situated franchisee” for purposes of determining if ADQ’s requirements were non-discriminatory was too narrow, and citing Andy Mohr Truck Center, stated, “precise equivalence is not required; the parties must be comparable, not clones.”

The court denied in part and reserved in part ADQ’s motion. The court ruled that the evidence of non-compliance by franchisees in other states is relevant to Universal’s claim that ADQ’s requirements were “reasonable and essential.”

II. State Law Good Cause Requirements

If a state does not have an anti-discrimination statute, franchisees often bring claims of discriminatory enforcement of the franchise agreement by relying on the “good cause” requirements of a state’s relationship laws that govern when a franchisor can terminate or not renew a franchise agreement, or in some cases, deny transfers.

A. California

Section 20020 of the California Franchise Relations Act (CFRA), which was amended in 2016, states:

Except as otherwise provided by this chapter, no franchisor may terminate a franchise prior to the expiration of its term, except for good cause. Except as provided in Section 20021, good cause shall be limited to the failure of the franchisee to substantially comply [emphasis added] with the lawful requirements imposed upon the franchisee by the franchise agreement after being given notice at least 60 days in advance of the termination and a reasonable opportunity, which in no event shall be less than 60 days from the date of the notice of noncompliance, to cure the failure. The period to exercise the right to cure shall not exceed 75 days unless there is a separate agreement between the franchisor and franchisee to extend the time.

Prior to the 2016 amendment to the CFRA, good cause was deemed to have occurred for a franchisee’s failure to comply with any lawful requirement of the franchise agreement. Changing the requirement to “substantially comply” arguably makes it more difficult for franchisors to terminate franchise agreements in California if the franchisor is not uniformly enforcing the agreement or standards.

Section 20021 provides a list of occurrences deemed “reasonable” under the CFRA such that franchisors may terminate the franchise agreement immediately upon notice without providing the franchisee an opportunity to

52. Id.
53. Id. at *3–4.
54. Id. at *11.
55. Id. at *5.
cure. These defaults include, among others, abandonment of the business, failure to pay amounts due under the franchise agreement, bankruptcy or insolvency, or repeated non-compliance/multiple defaults.

With the 2016 amendment, the California legislature provided franchisees statutory remedies if franchisors violate the CFRA. Therefore, in addition to relying on claims of discriminatory treatment, if a franchisor terminates or fails to renew a franchise agreement in violation of the CFRA, the affected franchisee is entitled to receive from the franchisor payment equal to the fair market value of the franchised business and its assets plus any other damages the franchisee can show it suffered; preliminary and injunctive relief are available to franchisees.\footnote{Id. § 20035.}

Whether or not a claim for discriminatory enforcement is brought, or if brought, whether or not the franchisee prevails on the claim, the CFRA now provides remedies to franchisees if the termination was lawful and the franchisor retains control of the franchised business premises:

[U]pon a lawful termination or nonrenewal of a franchisee, the franchisor shall purchase from the franchisee, at the value of price paid, minus depreciation, all inventory, supplies, equipment, fixtures, and furnishings purchased or paid for under the terms of the franchise agreement or any ancillary or collateral agreement by the franchisee to the franchisor or its approved suppliers and sources, that are, at the time of the notice of termination or nonrenewal, in the possession of the franchisee or used by the franchisee in the franchise business.\footnote{Id. § 20022.}

B. Connecticut

Connecticut’s franchise relationship laws state, “No franchisor shall, directly, or through any officer, agent or employee, terminate, cancel or fail to renew a franchise, except for good cause, which shall include, but not be limited to the franchisee’s refusal or failure to comply substantially with any material and reasonable obligation of the franchise agreement . . .”\footnote{Conn. Gen. Stat. Ann. § 42-133f(a).}

C. Hawaii

In addition to the specific anti-discrimination provisions described above, the Hawaii Franchise Investment Law also provides for a “good cause” standard that franchisors must comply with when considering terminations and transfers.

When making a determination whether or not to terminate a franchise agreement, a franchisor may not, without subjecting itself to claims of unfair or deceptive practices,

[terminate or refuse to renew a franchise except for good cause, or in accordance with the current terms and standards established by the franchisor then equally applicable to all franchisees, unless and to the extent that the franchisor satisfies the burden of proving that any classification of or discrimination between franchisees
is reasonable, is based on proper and justifiable distinctions considering the purposes of this chapter, and is not arbitrary. For purposes of this paragraph, good cause in a termination case shall include, but not be limited to, the failure of the franchisee to comply with any lawful, material provision of the franchise agreement after having been given written notice thereof and an opportunity to cure the failure within a reasonable period of time.\textsuperscript{60}

Franchisors must comply with a different “good cause” standard when considering a franchisee’s request to transfer the franchise. As with terminations, a franchisor may not, without subjecting itself to claims of unfair or deceptive practices,

[r]efuse to permit a transfer of ownership of a franchise, or of a proprietorship, partnership, corporation or other business entity that is a franchisee or subfranchisor, except for good cause. For purposes of this paragraph good cause shall include, but not be limited to:

(i) The failure of a proposed transferee to meet any of the franchisor’s or subfranchisor’s reasonable qualifications or standards then in effect for a franchisee or subfranchisor;

(ii) The fact that the proposed transferee or any affiliated person of the proposed transferee is a competitor of the franchisor or subfranchisor;

(iii) The inability or unwillingness of the proposed transferee to agree in writing to comply with and be bound by all lawful obligations imposed by the franchise, including without limitation all instruction and training obligations, and to sign the current form of franchise agreement used by the franchisor or subfranchisor; and

(iv) The failure of the franchisee or proposed transferee to pay any sums owing to the franchisor and to cure any default in the franchise agreement or other agreements with the franchisor existing at the time of the proposed transfer.\textsuperscript{61}

Much like the remedies that are now afforded franchisees in California, at the time of the termination or expiration of the franchise, franchisees in Hawaii must be compensated for the fair market value of the franchisee’s inventory, supplies, equipment, and furnishings.\textsuperscript{62} Additionally, if the franchisor refuses to renew a franchise for the purpose of converting the franchisee’s business to one owned and operated by the franchisor, the franchisor must compensate the franchisee for the loss of goodwill associated with the franchised business.\textsuperscript{63}

D. Iowa

In Iowa, “a franchisor shall not terminate a franchise prior to the expiration of its term except for good cause.”\textsuperscript{64} “Good cause” is based upon a le-

\textsuperscript{61} Id. § 482E-6(2)(I).
\textsuperscript{62} Id. § 482E-6(3).
\textsuperscript{63} Id.
\textsuperscript{64} Iowa Code Ann. § 523H.7. Iowa Code Ann. § 537A.10.7, which applies to franchise agreements entered into after July 1, 2000, has similar language, but does not have the language regarding comparison to the franchisor’s actions in similar circumstances.
gitimate business reason and includes the failure of the franchisee to comply with any material lawful requirement of the franchise agreement, provided that the termination by the franchisor is not arbitrary or capricious when compared to the actions of the franchisor in other similar circumstances.”65

In Iowa, the franchisee has the burden of proof of showing that the franchisor’s action is arbitrary or capricious.66

E. Michigan

Under the Michigan Franchise Investment Law (MFIL), “a [franchise agreement] provision that permits a franchisor to terminate a franchise prior to the expiration of its term except for good cause” is deemed void and unenforceable.67 “Good cause shall include the failure of the franchisee to comply with any lawful provision of the franchise agreement and to cure such failure after being given written notice thereof and a reasonable opportunity, which in no event need be more than 30 days, to cure such failure.”68

A different definition of “good cause” applies to transfers. A transfer provision is deemed void and unenforceable if:

[it] permits a franchisor to refuse to permit a transfer of ownership of a franchise, except for good cause. . . . Good cause shall include, but is not limited to: (i) The failure of the proposed transferee to meet the franchisor’s then current reasonable qualifications or standards. (ii) The fact that the proposed transferee is a competitor of the franchisor or subfranchisor. (iii) The unwillingness of the proposed transferee to agree in writing to comply with all lawful obligations. (iv) The failure of the franchisee or proposed transferee to pay any sums owing to the franchisor or to cure any default in the franchise agreement existing at the time of the proposed transfer.69

Additionally, while the word “discriminatory” is not used in the statute, the MFIL makes a provision void and unenforceable if the provision permits the franchisor to refuse to renew a franchise on terms generally available to other franchisees of the same class or type under similar circumstances.70

In Tractor and Farm Supply, Inc. v. Ford New Holland, Inc., the dealer entered into a dealership agreement with New Holland that provided for a three-year extension, unless either party gave a six-month notice of its intent not to renew; either party could choose not to renew without cause.71 Neither party gave notice of non-renewal, so the agreement renewed for its first renewal term. During the renewal term, New Holland notified the plaintiff that it would not be renewing the agreement.72

65. Id.
66. Id.
68. Id.
69. Id. § 445.1527(g).
70. Id. § 445.1527(e).
72. Id.
The plaintiff alleged that it had consistently met New Holland’s sales and performance requirements and that New Holland’s decision not to renew was based on animosity toward the son of the owner of the plaintiff entity and New Holland’s desire to consolidate dealerships in plaintiff’s area.\(^73\)

Applying the MFIL, and citing General Aviation, Inc. v. Cessna Aircraft Co.,\(^74\) the U.S. District Court for the Western District of Kentucky found that all similarly situated franchisees must be treated similarly and that sufficient facts were alleged to suggest that New Holland’s decision not to renew the agreement was based on discriminatory and unequal treatment.\(^75\)

F. Minnesota

Under Minnesota’s franchise law, “No person, whether by means of a term or condition of a franchise or otherwise, shall engage in any unfair or inequitable practice in contravention of such rules as the commissioner may adopt defining as to franchises the words ‘unfair and inequitable.’”\(^76\) The statute also contains requirements relating specifically to terminations, renewals, and transfers, and any violation of these requirements is considered an “unfair and inequitable practice” under the statute.\(^77\)

Franchisors cannot terminate a franchise agreement without good cause. “Good cause” means failure by the franchisee to substantially comply with the material and reasonable franchise requirements imposed by the franchisor including, but not limited to:

1. the bankruptcy or insolvency of the franchisee;
2. assignment for the benefit of creditors or similar disposition of the assets of the franchise business;
3. voluntary abandonment of the franchise business;
4. conviction or a plea of guilty or no contest to a charge of violating any law relating to the franchise business; or
5. any act by or conduct of the franchisee which materially impairs the goodwill associated with the franchisor’s trademark, trade name, service mark, logo-type or other commercial symbol.\(^78\)

The same definition of “good cause” applies to renewals. Unless the failure to renew a franchise is for good cause and the franchisee has failed to cure the deficiencies, franchisors cannot fail to renew a franchise agreement unless (1) the franchisee has been given written notice of the intention not to renew at least 180 days in advance of the expiration of the franchise; and (2) the franchisee has been given an opportunity to operate the franchise over a sufficient period of time to enable the franchisee to recover the fair

\(^{73}\) Id. at 1205.
\(^{74}\) 13 F.3d 178, 180–83 (6th Cir. 1993).
\(^{75}\) Tractor & Farm Supply, 898 F. Supp. at 1205.
\(^{77}\) Id. § 80C.14(2).
\(^{78}\) Id. § 80C.14(3)(b).
market value of the franchise as a going concern, as determined and measured from the date of the failure to renew. Additionally, franchisors cannot refuse to renew a franchise if the refusal is for the purpose of converting the franchisee’s business premises to an operation that will be owned by the franchisor for its own account.

G. Nebraska

Under the Nebraska Franchise Practices Act, franchisors cannot terminate or fail to renew a franchise agreement without good cause, but the statute specifically states, “This subsection shall not prohibit a franchise from providing that the franchise is not renewable or that the franchise is only renewable if the franchisor or franchisee meets certain reasonable conditions.” “Good cause” means the franchisee’s failure to substantially comply with requirements imposed by the franchisor.

H. New Jersey

Termination and renewal requirements under the New Jersey Franchise Practices Act are almost identical to those in Nebraska. Franchisors cannot terminate or fail to renew a franchise agreement without good cause, and “good cause” means the franchisee’s failure to substantially comply with requirements imposed by the franchisor.

I. Virginia

The Virginia Retail Franchising Act states that it is “unlawful for a franchisor to cancel a franchise without reasonable cause or to use undue influence to induce a franchisee to surrender any right given to him by any provision contained in the franchise.”

J. Washington

Like other states with anti-discrimination provisions, the Washington Franchise Investment Protection Act (WFIPA) also contains a “good cause” requirement for terminations. Under WFIPA, when making a determination whether or not to terminate a franchise agreement, a franchisor may not, without subjecting itself to claims of unfair or deceptive practices,

[t]erminate a franchise prior to the expiration of its term except for good cause. Good cause shall include, without limitation, the failure of the franchisee to comply with lawful material provisions of the franchise or other agreement between the franchisor and the franchisee and to cure such default after being given written notice thereof and a reasonable opportunity, which in no event need be more than

79. Id. § 80C.14(4).
80. Id.
81. NEB. REV. STAT. ANN. § 87-404(1).
82. Id. § 87-402(8).
83. N.J. STAT. ANN. § 56:10-5.
84. VA. CODE ANN. § 13.1-564.
thirty days, to cure such default, or if such default cannot reasonably be cured within thirty days, the failure of the franchisee to initiate within thirty days substantial and continuing action to cure such default: PROVIDED, that after three willful and material breaches of the same term of the franchise agreement occurring within a twelve-month period, for which the franchisee has been given notice and an opportunity to cure as provided in this subsection, the franchisor may terminate the agreement upon any subsequent willful and material breach of the same term within the twelve-month period without providing notice or opportunity to cure: PROVIDED FURTHER, that a franchisor may terminate a franchise without giving prior notice or opportunity to cure a default if the franchisee: (i) is adjudicated a bankrupt or insolvent; (ii) makes an assignment for the benefit of creditors or similar disposition of the assets of the franchise business; (iii) voluntarily abandons the franchise business; or (iv) is convicted of or pleads guilty or no contest to a charge of violating any law relating to the franchise business. Upon termination for good cause, the franchisor shall purchase from the franchisee at a fair market value at the time of termination, the franchisee’s inventory and supplies, exclusive of (i) personalized materials which have no value to the franchisor; (ii) inventory and supplies not reasonably required in the conduct of the franchise business; and (iii), if the franchisee is to retain control of the premises of the franchise business, any inventory and supplies not purchased from the franchisor or on his or her express requirement. 85

However, in the case of renewals, the WFIPA does not contain a “good cause” requirement. If a franchisor does not allow a franchisee to renew its franchise agreement, regardless of the reason, the franchisor cannot:

[r]efuse to renew a franchise without fairly compensating the franchisee for the fair market value, at the time of expiration of the franchise, of the franchisee’s inventory, supplies, equipment, and furnishings purchased from the franchisor, and good will, exclusive of personalized materials which have no value to the franchisor, and inventory, supplies, equipment, and furnishings not reasonably required in the conduct of the franchise business. 86

Franchisors, however, do not have to compensate franchisees for goodwill if (1) the franchisee has been given one year’s notice of nonrenewal; and (2) the franchisor agrees in writing not to enforce any covenant that restrains the franchisee from competing with the franchisor. 87

III. Industry Specific Statutes

Beyond state relationship laws governing franchising, special industry relationship statutes often offer franchisees key protections against selective enforcement of franchise agreements where such laws apply. 88 There are four main categories of special industry statutes: those governing petroleum

86. Id. § 19.100.180(2)(i).
87. Id.
marketing (i.e., motor fuel), automobile manufacturers and dealers, beer (and other alcoholic beverage) distributorships, and heavy equipment dealers. 89

Specifically, the Petroleum Marketing Practices Act and the Automobile Dealer Franchise Act are federal statutes; forty-nine states have enacted automobile dealership statutes; all states regulate the distribution of alcohol to varying degrees; and forty-five states have enacted in varying scopes statutes regulating some form of equipment dealerships. 90 There are significant similarities between state relationship laws and these special industry statutes. For example, automobile dealers led the charge on requiring manufacturers to demonstrate “good cause” when terminating or failing to renew the relationship. 91 More broadly, the theme of “good cause” for termination and nonrenewal by franchisors is present throughout these statutes. 92

A. Petroleum Marketing Practices Act (PMPA)

Congress attempted to address the perceived disparity in position between gasoline dealers and oil companies by creating prohibitions against franchisors unfairly ending or failing to renew motor fuel franchises for arbitrary or discriminatory reasons. 93 Unlike the protections offered by certain state anti-discrimination statutes and franchise relationship laws, the Petroleum Marketing Practices Act offers motor fuel dealers limited protections at the potential conclusion of franchise relationships, i.e., the PMPA applies in the limited scope of “unfair” termination or renewal. Under the provisions of the PMPA, there are limited circumstances in which a franchisor can terminate or not renew a franchise. At its core, the PMPA establishes guardrails on a franchisor’s ability to selectively enforce its franchise agreements by limiting franchisors to specific reasons for termination or nonrenewal. 94 The following are permissible reasons for termination or nonrenewal of the franchise relationship by a franchisor as long as the franchisor satisfies the applicable notice requirements:

(1) “A failure by the franchisee to comply with any provision of the franchise, which provision is both reasonable and of material significance to the franchise relationship . . .” 95

(2) “A failure by the franchisee to exert good faith efforts to carry out the provisions of the franchise, if [the franchisee was apprised by the franchisor in writing of such failure and was afforded a reasonable opportunity to exert good faith efforts to carry out such provisions . . .” 96

89. Id.
90. Id.
91. Id.
92. Id.
93. Id. at 2.
94. Id.
(3) “The occurrence of an event which is relevant to the franchise relationship and as a result of which termination of the franchise or non-renewal of the franchise relationship is reasonable, if such event occurs during the period the franchise is in effect . . .”

In the PMPA, Congress provides twelve examples of qualifying events, including fraud/criminal misconduct by a franchisee related to the operation of the business, franchisee’s bankruptcy or insolvency, failure by the franchisee to pay amounts owed to the franchisor, and failure to operate by the business for seven days.

The PMPA also provides the following reasons for nonrenewal:

(A) The failure of the franchisor and the franchisee to agree to changes or additions to the provisions of the franchise, if—

(i) such changes or additions are the result of determinations made by the franchisor in good faith and in the normal course of business; and

(ii) such failure is not the result of the franchisor’s insistence upon such changes or additions for the purpose of converting the leased marketing premises to operation by employees or agents of the franchisor for the benefit of the franchisor or otherwise preventing the renewal of the franchise relationship.

(B) The receipt of numerous bona fide customer complaints by the franchisor concerning the franchisee’s operation of the marketing premises, if—

(i) the franchisee was promptly apprised of the existence and nature of such complaints following receipt of such complaints by the franchisor; and

(ii) if such complaints related to the condition of such premises or to the conduct of any employee of such franchisee, the franchisee did not promptly take action to cure or correct the basis of such complaints.

(C) A failure by the franchisee to operate the marketing premises in a clean, safe, and healthful manner, if the franchisee failed to do so on two or more previous occasions and the franchisor notified the franchisee of such failures.

(D) [Intentionally Omitted].

However, the PMPA does not govern every aspect of the franchise relationship. The U.S. Supreme Court in *Mac’s Shell Service v. Shell Oil Products Co. LLC* refused to expand the scope of the PMPA’s reach to constructive termination, reasoning that the PMPA’s scope was drafted narrowly by Congress with the primary concern of preventing franchisors from the “imposition of arbitrary and unreasonable new terms on a franchisee that are designed to force an end to the petroleum franchise relationship.” As such, the PMPA has limited preemptive effect, so other state and federal laws will govern other aspects of the franchise relationship.

100. Garner et al., *supra* note 88, at 3.
101. 559 U.S. 175, 194 (2010).
B. Automobile/Motor Vehicle Dealer Laws

Congress enacted the federal Automobile Dealer Franchise Act in 1956, making a federal claim available to dealers if a manufacturer of automobiles breaches its dealer agreement without good faith. The Dealer Act provides:

An automobile dealer may bring suit against any automobile manufacturer . . . and shall recover the damages by him sustained and the cost of suit by reason of the failure of said automobile manufacturer . . . to act in good faith in performing or complying with any of the terms or provisions of the franchise, or in terminating, canceling, or not renewing the franchise with said dealer: Provided, That in any such suit the manufacturer shall not be barred from asserting in defense of any such action the failure of the dealer to act in good faith.

However, the statute narrowly defines “good faith,” so dealers are faced with a heavy burden to demonstrate that manufacturer acted without good faith. “Good faith” under the Dealer Act does not have the same meaning as the term has in the franchise context nor is it analogous to the covenant of good faith and fear dealing at common law. Under the Dealer Act, “good faith” means:

[T]he duty of each party to any franchise, . . . to act in a fair and equitable manner toward each other so as to guarantee the one party freedom from coercion, intimidation, or threats of coercion or intimidation from the other party: provided, that recommendation, endorsement, exposition, persuasion, urging or argument shall not be deemed to constitute a lack of good faith.

As compared to the franchise concept of “good faith,” it is much harder for a franchisee to demonstrate that franchisor acted in such a way that the franchisee was coerced, intimidated, or threatened.

In addition to the Dealer Act, as of 2009, all states had enacted motor vehicle franchise laws that prohibited termination or nonrenewal by a manufacturer without “good cause.” There are varying definitions of “good cause” under these state laws. For example, in Wisconsin, a manufacturer is prohibited from “unfairly, without due regard to the equities of the dealer and without just provocation, cancel[ing] the franchise of a motor vehicle dealer, or . . . distributor.” The Minnesota Motor Vehicle Sale and Distribution Act (MMVSDA) prohibits a manufacturer from canceling, terminating, or failing to renew a franchise relationship without good cause for such action. The MMVSDA provides that:

103. Id.
106. Id. at 31.
109. W I S. S TAT. § 218.0116(i)(2).
110. M I N N. S TAT. A NN. § 80E.06.
Good cause exists for the purposes of a termination, cancellation, or nonrenewal, when the new motor vehicle dealer fails to comply with a provision of the franchise which is both reasonable and of material significance to the franchise relationship; provided, that the dealer has been notified in writing of the failure within 180 days after the manufacturer first acquired knowledge of the failure.

If failure by the new motor vehicle dealer relates to the performance of the new motor vehicle dealer in sales or service, then good cause shall be defined as the failure of the new motor vehicle dealer to comply with reasonable performance criteria established by the manufacturer; provided, that the new motor vehicle dealer was apprised by the manufacturer in writing of the failure; the notification stated that notice was provided for failure of performance pursuant to sections 80E.01 to 80E.17; the new motor vehicle dealer was afforded a reasonable opportunity in no event less than six months to comply with the criteria; and the dealer did not demonstrate substantial progress toward compliance with the manufacturer’s performance criteria during the period. . . .

Some state statutes have extensive definitions of “good cause,” which expressly prohibit franchisors from selectively enforcing the terms of their dealer agreements. Under the South Dakota Dealership Act, “[n]o franchisor may . . . terminate, cancel, fail to renew, or substantially change the competitive circumstances of a vehicle dealership agreement without good cause.” The statute defines “good cause” as “a failure by a vehicle dealer to substantially comply with essential and reasonable requirements imposed upon the vehicle dealer by the vehicle dealership agreement, if the requirements are not different from those requirements imposed on other similarly situated vehicle dealers by their terms.” However, many of these state statutes do not clearly define what constitutes “good cause.”

Some of the state motor vehicle laws expressly prohibit manufacturers from discriminating among franchisees during the term of the franchise agreement. For example, many states prohibit manufacturers from price discrimination among its dealers. Florida law requires that manufacturers make the same incentives available to dealers in Florida that it offers to all of its other same line-make dealers nationally or to all of its other same line-make dealers in the licensee’s designated zone, region, or other licensee-designated area of which this state is a part, unless the failure or refusal to offer the program in this state is reasonably supported by substantially different economic or marketing considerations than are applicable to the licensee’s same line-make dealers in this state.
In short, motor vehicle manufacturers must carefully examine applicable state laws when examining any action/inaction that may result in disparate treatment of dealers.

C. Beer Distributorship Laws

As compared to the petroleum marketing and motor vehicle industries, beer distributors are faced with a complex legal landscape because there is no federal statutory scheme with preemptive effect. After the conclusion of Prohibition, the Twenty-first Amendment granted states primary authority to regulate alcohol within their borders, so the relationship between brewers and distributors is governed by a patchwork of laws that varies significantly from state to state. Like general business format franchise laws, state beer franchise laws “seek to protect franchisees or distributors against oppressive conduct in the ongoing relationship and against being terminated without good cause.” As a result, like state relationship laws, state distributorship laws are often “franchisee” protective. While there is no disclosure requirement at the dawn of the relationship, “states regulate the relationships between those who brew or import beer into the state (brewers) and those who receive, warehouse, and distribute beer to retailers (distributors).”

Most states have adopted a three-tier distributor system separating brewers/suppliers, distributors/wholesalers, and retailers/resellers/taverns. States such as Texas, Illinois, and Utah have passed legislation requiring good faith dealings between parties to distributorship agreements, analogous in some ways to state relationship laws for general business format franchises.

These state laws often prohibit franchisors (or brewers) from terminating (in certain cases nonrenewing) franchisees/distributors based on good cause and provide certain protections, including prohibition of inventory purchasing requirements, imposition of inventory repurchase requirements on franchisors, and transfer and territory protections. As with motor vehicle dealership laws, most state laws require good cause for termination or nonrenewal. States vary widely in their interpretations as to what constitutes “good cause” in this context. Oregon law provides that “[f]or each dispute arising out of an allegation of bad faith termination or for termination for other than good cause, the supplier shall have the burden of proving that it acted reasonably and in good faith, that good cause existed for any termination, cancellation, discontinu-

118. Id.
119. Id.
120. Id.
121. Id.
122. Id. at 18.
123. Id. at 21.
124. Id.
125. Id. at 23.
126. Id.
ance or nonrenewal and that the supplier complied with the applicable requirements of the law.” 127 Missouri law provides that “no supplier shall unilaterally terminate or refuse to continue or change substantially the condition of any franchise with the wholesaler unless the supplier has first established good cause for such termination, non-continuance or change.” 128 Missouri also provides a definition for both “good faith” and “good cause.” 129 “Good faith” is defined as a “duty of each party to any franchise and all officers, employees or agents thereof to act in a fair and equitable manner towards each other.” 130 “Good cause” is defined as:

1. Failure by the wholesaler to comply substantially with the provisions of an agreement or understanding with the supplier, which provisions are both essential and reasonable;

2. Use of bad faith or failure to observe reasonable commercial standards of fair dealing in the trade; or

3. Revocation or suspension for more than thirty-one days of a beer wholesaler’s federal basic permit or of any state or local license required of a beer wholesaler for the normal operation of its business. 131

In addition to “good cause” requirements for termination and nonrenewal, some states impose specific limitations related to certain brewer/supplier actions during the term of the relationship. Some laws expressly prohibit selective enforcement of franchise agreements. For example, under Iowa law, a brewer may not “[d]iscriminate among the brewer’s wholesalers in any business dealings including, but not limited to, the price of beer sold to the wholesaler or terms of sale offered to wholesalers, unless the difference among its wholesalers is based on reasonable grounds.” 132

In Missouri, “[i]f more than one franchise for the same brand or brands of intoxicating liquor is granted to different wholesalers in this state, it is a violation . . . for any supplier to discriminate between the wholesalers with respect to any of the terms, provisions, and conditions of these franchises.” 133 Likewise, under the Illinois Beer Industry Fair Dealing Act, “[a] brewer may amend an agreement including operating standards at any time without the wholesaler’s consent if such amendment does not materially, substantially, and adversely affect the wholesaler and such amendment is effective as to all wholesalers of the brewer in the State.” 134

In Idaho, “a supplier may impose reasonable inventory requirements upon a distributor if the requirements are made in good faith and are generally applied to other distributors in Idaho and similarly situated distributors in ad-

129. Id.
130. Id.
131. Id.
joining states having an agreement with the supplier.” 135 In Oregon, a sup-
plier is prohibited from denying or delaying a proposed assignment of a dis-
tributorship “if the wholesaler has provided the supplier with written notice
of the intent to transfer and the transferee meets reasonable standards and
qualifications required by the supplier which are nondiscriminatory and
are applied uniformly to all wholesalers similarly situated.” 136

IV. Selective Enforcement at Common Law

As previously described, most states have not enacted statutes prohibiting
the selective enforcement of franchise agreements. As such, courts often ig-
nore the inconsistent treatment of franchisees as a defense to the termination
of franchise agreements. In these states, and in states where such statutes do
exist, franchisees use the following common law theories to bring claims of
wrongful termination and to bolster their statutory claims.

A. Waiver and Estoppel

Franchisees may object to selective enforcement of franchise agreement
terms based on the theories of waiver and estoppel. While frequently refer-
cenced together, waiver and estoppel are distinct legal principles. Waiver oc-
curs when a party to a contract, aware that the other party has not fulfilled its
respective obligations, knowingly fails to enforce provisions of its agreement
or fails to perform its obligations under the contract. 137 Estoppel is an avail-
able claim when there is “(1) action or inaction, (2) on the part of one against
whom estoppel is asserted, (3) which induces reasonable reliance thereon by
the other, either in action or inaction, and (4) which is to his or her detri-
ment.” 138 To successfully assert estoppel, a party must demonstrate that it
reasonably and detrimentally relied on such action or inaction. 139

For example, where a franchisor knowingly fails to require franchisees to
comply with contractual advertising requirements for a period, eventually re-
instates such requirements, and then refuses to renew a franchisee for lack of
compliance, a franchisee may resort to theories of waiver and estoppel in re-
sponse to such nonrenewal, even if anti-discrimination statutes and special
industry laws are not available. Specifically, a franchisee may argue that the
franchisor is estopped from enforcing the advertising requirements based on
its prior course of dealing.

In Robinson v. Charter Practices, International, LLC, a franchisor of veteri-
nary clinics elected not to enforce the in-term noncompetition provision
of its franchise agreement with the plaintiff during the initial term of the

136. OR. REV. STAT. ANN. § 474.045.
137. Kerry L. Bundy & Scott H. Ikeda, How Waiver, Modification, and Estoppel May Alter Fran-
138. Id. at 4.
139. Id.
franchise agreement. The plaintiff owned several other independent, non-affiliated veterinary clinics, and at renewal, the franchisor informed plaintiff that it would enforce the in-term noncompetition provision in the agreement during the renewal term. The franchisee did not sell its other independent clinics, and the parties did not renew the franchise agreement. The plaintiff sued the franchisor, alleging that the franchisor’s failure to renew the agreement was a breach of the franchise agreement. In support of this claim, the plaintiff argued that the franchisor had waived, and was estopped from enforcing, the noncompetition provision by its failure to enforce such provision during the initial term of the franchise agreement. The court held that although the franchisor waived the noncompetition provision in the first franchise agreement, its course of dealing did not constitute waiver of the provision in the renewal agreement. It is important to note that the renewal requirements in the initial franchise agreement conditioned renewal on the franchisee’s compliance with the noncompetition provision.

While the franchisor prevailed in the Robinson case, the court may have reached a different result if the franchisor attempted to enforce the non-competition provision mid-term. A plaintiff’s waiver and estoppel arguments would be strengthened where a franchisee can demonstrate that a franchisor has knowingly allowed or permitted other franchisees to take the same actions at issue.

Regardless, in many instances, franchisors avoid waiver claims by including no-waiver clauses in their agreements. These clauses are both enforced and invalidated by courts based on the applicable state laws and the surrounding circumstances. Other courts have taken a middle of the road approach to the application of no-waiver clauses, considering the specific facts at hand in light of the applicable state law.

In short, it is critical that franchisors promptly address noncompliance because there is a risk that inaction will arm franchisees with waiver and estoppel arguments. To mitigate some of this risk, a franchisor might consider communicating new, revised enforcement plans to franchisees in advance of implementation. These types of communications put all franchisees on notice of new enforcement standards or practices, and they should serve to lessen the veracity of franchisees who claim they were not aware of such new policies.

140. 696 F. App’x 226, 227 (9th Cir. 2017).
141. Id.
142. Id.
143. Id.
144. Id. at 228.
145. Bundy & Ikeda, supra note 137, at 3.
146. Id. at 5.
147. Id. at 7.
B. Covenant of Good Faith and Fair Dealing

As discussed above, at common law, franchisors are not barred from selectively enforcing franchise agreements. However, the covenant of good faith and fair dealing is recognized in most states as an implied duty in all commercial contracts.\(^{148}\) Even though the covenant of good faith and fair dealing does not provide an independent source of duties for the parties to the contract, where a franchisor disparately enforces its franchise agreement or policies, in certain scenarios, a franchisee may prevail on a claim for breach of the implied covenant of good faith and fair dealing.\(^{149}\)

In *Valley Stream Foreign Cars, Inc. v. American Honda Motor Co., Inc.*, a motor vehicle dealer brought a claim against the American Honda Motor Co., Inc., alleging, among other claims, breach of the implied covenant of good faith and fair dealing based on American Honda’s failure to strictly enforce its dealer agreement.\(^{150}\) American Honda’s dealer agreement included a provision that a dealer agrees to “[a]bide by all other terms and conditions of this Dealer Agreement and American Honda’s Policies and Procedures.”\(^{151}\) The dealer agreement’s definition of “Policies and Procedures” included “policies and procedures prepared by American Honda in its sole discretion based upon American Honda’s evaluation of Dealer’s business, American Honda’s business, its Dealer body, and the marketplace, and which may be established and/or amended by American Honda from time to time.”\(^{152}\) American Honda adopted a “Wholesaling Policy” that required dealers to refrain from wholesaling Honda vehicles, stating that it “considers any Wholesaling to be consistent with the Dealer Agreement.” The dealer alleged that: (1) other Honda dealers located outside of the plaintiff dealer’s Area of Statistical Analysis (ASA) were engaging in wholesaling; (2) American Honda had received information about the wholesaling; and (3) American Honda had received information about the wholesaling; and (3) American

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149. Am. Casual Dining, L.P. v. Moe’s Southwest Grill, L.L.C., 426 F. Supp. 2d 1356, 1370 (N.D. Ga. 2006) (citing Alan’s of Atlanta, Inc. v. Minolta Corp., 903 F.2d 1414, 1429 (11th Cir. 1990)); see also C.K.H., LLC v. Quizno’s Master, LLC, Bus. Franchise Guide (CCH) ¶ 13,027 (D. Colo. 2005) (stating that the duty of good faith and fair dealing does not inject substantive terms into the parties’ contract; rather, it requires only that the parties perform in good faith the obligations imposed by their agreement.).


151. Id. at 550.

152. Id.
Honda “has not initiated audits of those [d]ealers or otherwise taken any steps to curtail the [w]holesaling.”\textsuperscript{153} The plaintiff dealer also alleged that this failure by American Honda to strictly enforce the dealer agreement negatively impacted American Honda’s evaluation of the plaintiff dealer’s sales performance, ultimately causing the plaintiff to lose numerous sales of Honda vehicles in its ASA as well as the profits generated from such sales.\textsuperscript{154}

In its decision, the U.S. District Court for the Eastern District of New York acknowledged that there are cases where the courts have declined to find that “franchisors [are] obligated to enforce franchise standards against particular franchisees.”\textsuperscript{155} Instead of looking to the express language of the parties’ contract, the court considered the course of performance and dealing when examining whether a party has breached the obligation of good faith and fair dealing.\textsuperscript{156}

The court appeared to be persuaded that the plaintiff dealer did not simply allege a lack of strict enforcement but “rather a complete abandonment of any enforcement.”\textsuperscript{157} Because the wholesaling was so pervasive and American Honda was not taking steps to curtail it, the district court held that there was a plausible claim for a breach of the covenant of good faith and fair dealing, citing that “[w]here a contract contemplates the exercise of discretion, ‘[c]ourts have equated the covenant of good faith and fair dealing with an obligation to exercise that discretion reasonably and with proper motive, . . . not . . . arbitrarily, capriciously, or in a manner inconsistent with the reasonable expectations of the parties.’”\textsuperscript{158}

While franchisors may not be prohibited by statute or common law from selectively enforcing provisions of their franchise agreements, they should carefully consider whether such selective enforcement equates to a breach of the implied covenant of good faith and fair dealing, where the covenant exists. As such, franchisors should question whether selective enforcement creates arguments that such enforcement is arbitrary, capricious, or inconsistent with the parties’ expectations.

**Conclusion**

Franchisors should carefully consider how and why they enforce their franchise agreements. If a franchisor is concerned that action or inaction under a franchise agreement amounts to disparate treatment of franchisees, it should carefully consider taking such action. If the franchisor’s business is
regulated by an industry-specific statute, like the PMPA, it should tread care-
fully in selective enforcement of its agreements, particularly if such enforce-
ment leads to termination or nonrenewal. Regardless of the industry, a franchi-
sor should evaluate whether the rules of any state with anti-discrimination
statutes, i.e., Arkansas, Hawaii, Illinois, Indiana, Washington, and Wisconsin,
apply. Then, a franchisor should look to the state relationship law, if any, and
the definition and interpretations of good cause.

Absent restrictions presented by any of these items, state laws do not gener-
ally prohibit a franchisor from disparately enforcing its franchise agreements.
Where state anti-discrimination statutes and relationship laws do not offer relief
to franchisees, a franchisee may assert common law claims based on waiver and
estoppel or breaches of the covenant of good faith and fair dealing. The out-
come of these actions depends on the circumstances and the issues presented.
Therefore, even though these states may rule in favor of franchisors more
often than not, enforcing franchise agreements or system standards inconsist-
tently “because we can” most likely will not be a franchisor’s best defense.

Franchisors should also revisit the “boiler plate” language, including
choice of law and non-waiver provisions, in their form franchise agreements.
More importantly, a franchisor should take advantage of any opportunity it
has to consistently enforce its franchise agreement terms, bolstering its de-
defense to anti-discrimination claims and avoiding anti-discrimination claims
where possible. Although selective enforcement may not be prohibited by
law, it can easily lead to expensive and prolonged disputes with franchisees.
Franchising (& Distribution) Currents

Daniel J. Oates, Maral Kilejian, and Emily Bridges

ANTITRUST


The U.S. District Court for the Southern District of Iowa granted a motion to dismiss in favor of PepsiCo, Inc., finding that Mahaska Bottling Co. failed to set forth claims based on monopolization, predatory pricing, antitrust, business defamation, and the Lanham Act. Mahaska is an independent bottler of carbonated beverages that purchases concentrate inputs from suppliers such as PepsiCo. Mahaska accused PepsiCo of engaging in various unlawful actions to harm Mahaska. First, Mahaska claimed PepsiCo executed a “prize squeeze,” or predatory pricing, which occurs when a vertically integrated firm “squeezes” its competitors’ profit margins by raising the price of an essential input while also lowering prices in the end market in which the vertically integrated firm competes with the “squeezed” firm. Second, Mahaska alleged that PepsiCo engaged in exclusionary pricing and predatory pricing. Finally, Mahaska alleged violations of the Lanham Act.

The district court found that antitrust laws do not prohibit prices squeezes as alleged by Mahaska. Additionally, the court found that PepsiCo’s price increases did not have the characteristics of an anticompetitive refusal to deal, PepsiCo did not engage in predatory pricing, and there was no danger of monopolization. The district court also dismissed the business defamation and Lanham Act claims.

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BUSINESS OPPORTUNITY LAWS


This case is discussed under the topic heading “Choice of Law.”

CHOICE OF FORUM


This case is discussed under the topic heading “Choice of Law.”

CHOICE OF LAW


The U.S. District Court for the District of Arizona found that Ohio-based franchisees of hearing aid centers were not bound by the choice of law and venue provisions in their franchise agreements because such provisions are barred by the Ohio Business Opportunity Purchasers Protection Act. The franchise agreements included a provision requiring pre-suit mediation in Arizona, and Arizona law and venue for all litigation. In 2016, the franchisees brought suit in Ohio state court, alleging the franchisor (Zounds) had violated various provisions of the Act by failing to include a five-day cancellation right in the franchise agreements, making false and misleading representations in connection with the sale of the franchises, and presenting unsubstantiated monthly financial information not included in the mandatory disclosure documents. After the Ohio suit was filed, Zounds filed an action in Arizona seeking a declaratory judgment against the franchisees.

The Arizona court found that Ohio had the most significant relationship to the transactions and to the parties because all of the franchisees resided and operated their franchises in Ohio. The court further found that the statutory protections for franchisees, the foundation of the franchisees’ claims, reflected the fundamental public policy of Ohio. The court also held that Ohio had a materially greater interest than Arizona in the determination of the issues, and a contractual choice of law for the less protective Arizona law was contrary to fundamental Ohio public policy. Because substantive Ohio law bound the parties, the court held that the choice-of-law and venue provisions in the franchise agreements were invalid.
CONTRACT ISSUES


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


The North Carolina Superior Court granted in part and denied in part the franchisor’s (Superior) motion to dismiss. Several franchisees filed suit against Superior for various contract, statutory, and tort claims related to alleged “hidden” commissions Superior negotiated and received, but did not disclose to the franchisees.

The amended complaint asserted six claims: (1) unfair and deceptive trade practices; (2) breach of contract; (3) breach of the covenant of good faith and fair dealing; (4) fraud and negligent misrepresentation; (5) breach of fiduciary duty; and (6) declaratory judgment. The claims were based on allegations that Superior improperly negotiated direct commissions with insurance carriers for its benefit and to the plaintiffs’ detriment. The franchisor moved to dismiss all claims.

The court dismissed the unfair and deceptive trade practices claim to the extent it was based on the allegation that Superior failed to disclose certain commissions in violation of the Federal Trade Commission Franchise Rule because those claims were barred by the four-year statute of limitations. All of the franchisees had received the FDD omitting the disclosures more than six years before the lawsuit was filed. The court denied the motion to dismiss the unfair and deceptive trade practices claims to the extent the claims were based on the allegation that Superior violated the statute by “negotiating and failing to disclose” the hidden commission arrangement because it arose out of the same allegations underlying plaintiffs’ fraud and breach of contract claims, both of which were validly stated. Specifically, the court refused to dismiss the franchisees’ breach of contract/covenant of good faith and fair dealing claim because, in part, a factual dispute existed over the terms of the agreement. The court also refused to dismiss the fraud and negligent misrepresentation claims because the allegations in the complaint, although extremely vague, were sufficient to pass muster at the early stage of the litigation. The court rejected Superior’s argument that the three-year statute of limitations barred any contract claim because the franchisees had first learned of the breach by Superior two years before filing suit. The court dismissed the breach of fiduciary duty claim because Superior was not acting as the franchisees’ agent when negotiating commissions with insurance carriers. Finally, the court refused to dismiss the declaratory judgment claim to the
extent the franchisees sought a declaration invalidating all or part of the franchise agreements, but the court did dismiss the request to the extent it related to the noncompete provisions because no genuine controversy existed.

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

This case is discussed under the topic heading “FTC Franchising Rule.”

**DAMAGES**

_Sun Aviation, Inc. v. L-3 Commc’ns Avionics Sys., Inc.,_ Bus. Franchise Guide (CCH) ¶ 16,062, 533 S.W.3d 720 (Mo. 2017)
This case is discussed under the topic heading “Termination and Nonrenewal.”

**FRAUD**

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

**FTC FRANCHISING RULE**

Several Ohio-based Tim Hortons USA, Inc. franchisees brought suit against Tim Hortons when it refused to approve their proposals to transfer their franchised businesses to third parties. The franchisees alleged that the refusals by Tim Hortons violated Ohio’s Business Opportunity Plans Act and Deceptive Trade Practices Act because Tim Hortons failed to disclose in its Franchise Disclosure Document (FDD) that it retained the right to withhold consent to proposed transfers of franchises to third parties. The franchisees also alleged that Tim Hortons breached the franchise agreement, as well as the duty of good faith and fair dealing, by withholding consent. Finally, the franchisees contended that Tim Hortons made negligent or intentional misrepresentations by omitting information on transfer restrictions from the FDD.
Tim Hortons filed a motion to dismiss the claims in the U.S. District Court for the Southern District of Florida. The franchisees argued that the failure to disclose the transfer restrictions as required by the FTC Franchise Rule constituted a violation of the Ohio Deceptive Trade Practices Act. Addressing the issue of the statutory violations, the court noted that the FDDs did not include any notice that Tim Hortons could withhold consent to a transfer if the purchase price for the franchise exceeded the value of used equipment on the premises. Instead, the FDD merely stated that Tim Hortons retained the right to withhold consent to franchise transfers. The franchisees had received offers to purchase their franchised businesses for $4.4 million, far in excess of the $550,000 value of the equipment. As a result, Tim Hortons withheld consent to the transfers.

Although the details of Tim Hortons’s right to restrict transfers were not expressly set out in the FDD, it was described at length in the franchise agreements, which were attached as an exhibit to the FDD and provided to franchisees before they purchased their franchises. Accordingly, the court held that the FDD satisfied the requirements of the FTC Rule because the transfer restrictions were disclosed in the franchise agreements, which were included with the FDD. Moreover, the court noted that the applicable statute of limitations under the Ohio statutes for any claim was only two years. The plaintiffs had filed their lawsuit nearly three years after the last FDD had been provided; thus all potential disclosure claims were barred by Ohio’s two-year statute of limitations. The court declined to apply the discovery rule to save the claims from the statute of limitations, noting that all of the material information for the claims was set forth in the text of the franchise agreements. The franchisees had acknowledged, in writing, that they had read the franchise agreements, and had them reviewed by independent counsel, before they signed the agreements. For these reasons, the plaintiffs’ statutory claims were dismissed.

Conversely, the court declined to dismiss the breach of contract claims. The evidence showed that the franchisor had failed to undertake any due diligence into the proposed sale transaction and had withheld consent solely on the basis of the purchase price. The limitation on the purchase price contained in the franchise agreement applied only to franchises operated less than five years, however, and at least four of the five franchises had been in operation for more than five years. Although the contract on its face permitted Tim Hortons to arbitrarily withhold consent to a transfer, the language of the agreement was not without limits. As such, there remained a factual question whether Tim Hortons had failed in its contractual obligation to review and consent to transfers. But the court dismissed the plaintiffs’ claims for violations of the duty of good faith and fair dealing. Under Ohio law, as in many jurisdictions, the duty of good faith does not give rise to claims independent from the contract. As such, the plaintiffs’ claims were limited to those for breach of contract, and the court dismissed the duty of good faith claims.
Finally, the court also dismissed the negligent and intentional misrepresentation claims. Tim Hortons argued that because the FDD complied with the FTC Rule disclosure requirements, there were no negligent or intentional misrepresentations. The franchisee raised no contrary argument, and the court therefore deemed the claims conceded.

GOOD FAITH AND FAIR DEALING

This case is discussed under the topic heading “FTC Franchising Rule.”

INJUNCTIVE RELIEF

This case is discussed under the topic heading “Trademark Infringement.”

The Eleventh Circuit issued a per curiam opinion affirming the U.S. District Court for the Middle District of Florida’s denial of the franchisor’s motion for a preliminary injunction. World of Beer Franchising, Inc. (WOBF) sought to enjoin three of its former franchisees and their principal from using WOBF’s confidential information, marks, and trade dress, and from violating noncompetition provisions in their franchise agreements. The franchise agreements, however, included a provision stating that, although both parties had the right to obtain temporary restraining orders and temporary or preliminary injunctive relief, the parties must immediately and contemporaneously submit any dispute to non-binding mediation.

The court concluded that WOBF failed to submit its dispute to mediation immediately and contemporaneously with its request for injunctive relief. Because of this failure, the court held that the district court correctly denied WOBF’s motion for a preliminary injunction.

JURISDICTION

Three franchisors of car rental businesses, Dollar Rent a Car, Inc., Thrifty Rent-a-Car System, Inc., and the Hertz Corporation (franchisors) sued joint franchisee Westover Car Rental, LLC and several other individuals
in the U.S. District Court for the Middle District of Florida, claiming breach of contract and seeking a declaratory judgment on Westover’s obligation to comply with the post-termination noncompete provision in the franchise agreements. The franchisors alleged that the court had personal jurisdiction over all of the defendants based upon the consent to jurisdiction provisions in the franchise agreements. Westover, which was based in upstate New York, moved to dismiss, arguing that Florida law did not apply and the court lacked personal jurisdiction over the defendants.

The court initially noted that Florida law historically did not permit the exercise of personal jurisdiction based upon consent alone. Although the law now permits such exercise of jurisdiction, the consenting agreement must comply with Florida law. In order for such a consent to be valid, the contract must: (1) include a choice of law provision designating Florida law as the governing law; (2) include a provision whereby the non-resident agrees to submit to the jurisdiction of the courts of Florida; (3) involve consideration of not less than $250,000; (4) not violate the U.S. Constitution; and (5) either bear a substantial or reasonable relation to Florida or have at least one of the parties be a resident of Florida or incorporated under its laws. Applying those factors, the court noted that none of the franchise agreements contained a provision in which Westover expressly agreed to submit to the jurisdiction of the courts of Florida. Instead, the agreements contained floating forum selection clauses, which granted jurisdiction in any venue in which the franchisors currently operated their principal places of business. The court doubted this was sufficient, but declined to resolve the issue, instead noting that the courts lacked jurisdiction because the agreements did not include a Florida choice of law clause.

The court also rejected the franchisors’ contention that the court could exercise specific personal jurisdiction, notwithstanding the inapplicability of the contractual consent to jurisdiction. Westover’s business consisted of renting cars and parking cars in Western New York, and Westover had never solicited business in Florida or maintained an office there. The court found it insufficient that Westover sent a representative to Florida for a three-day training seminar, sent a franchise termination letter to Florida, and originally executed the contract by sending it to Florida. These contacts were merely incidental and initiated by the franchisors in Florida to their ultimate benefit.

Finally, the court rejected the franchisors’ contention that Westover breached a contractual obligation to perform specified acts in Florida: (1) pay franchise fees and (2) provide notice of termination. With respect to the franchise fees, Westover actually remitted payments to Tulsa, Oklahoma, not Florida. The same was true for the notice of termination, which was also sent to Tulsa. Because no actual contractual obligations were required to be performed in Florida, the court could not exercise personal jurisdiction over Westover and therefore granted the motion to dismiss.
LABOR AND EMPLOYMENT


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


The National Labor Relations Act (NLRA) does not define who is an employer. Rather, the NLRA states only that an employer includes “any person acting as an agent of an employer, directly or indirectly.” Since the early 1980s, the National Labor Relations Board (NLRB) and the courts uniformly have held that under the NLRA, an employer includes not only an employee’s direct employer, but also any third-party company that retains sufficient control over the terms and conditions of the employee’s employment. Thus, under long-standing precedent, a finding of joint employer required proof that the putative joint employer exercised joint control over the essential employment terms of the employee, and that the control was direct and immediate, and not merely limited and routine.

In 2016, in *Browning-Ferris Industries of California, Inc.*, the NLRB articulated a new standard for deciding what entities qualify as “joint employers” under the NLRA. The Board characterized the new standard as a means of addressing perceived policy concerns about an imbalance of leverage in commercial dealings between undisputed employers and third-party entities that prevented meaningful bargaining over the terms and conditions of employment. In other words, the Board perceived that changes in the economy resulted in an unfair bargaining position for employees who are limited to bargaining with their direct employers, even when the fruits of their labor benefited third-party entities. Under the new *Browning-Ferris* test, a third-party entity could be deemed a joint employer, even if it has never exercised joint control over essential terms and conditions of employment, and even if the joint control is neither direct nor immediate, provided the third party “reserves” control over the terms and conditions of employment, or merely exercises indirect control or limited and routine control. The *Browning-Ferris* decision greatly expanded the reach of the joint employer obligation to third-party independent contractors, as it was intended to, in order to ensure that third parties with deep pockets become participants in existing or newly bargained employment relationships.

Following *Browning-Ferris*, five employees of Hy-Brand Industrial Contractors Ltd. and two employees of Brandt Construction Co. were discharged after engaging in work stoppages based upon complaints over wages, benefits, and workplace safety. At the time, Terence Brandt served as corporate secretary for both companies. He was directly involved in the decision at both companies to discharge the employees, and he identified himself as an official of Brandt when he terminated the two employees of
Hy-Brand. He was also the primary individual for hiring at Brandt, and he hired the general manager of Hy-Brand. Employees of both companies participated in the same 401(k) and health benefit plans and were covered by the same workers compensation policies. The employees attended the same mandatory training sessions and annual corporate meetings where common employment policies were regularly reviewed. Following the termination, the employees brought their complaints to the NLRB, asserting that the work stoppages were protected concerted activity under the NLRA, and that Hy-Brand and Brandt were equally liable for these violations as joint employers.

In analyzing the case, the NLRB first began by assessing which standard should apply to determining whether Hy-Brand and Brandt were joint employers. In so doing, the NLRB rejected the *Browning-Ferris* standard for several non-exclusive reasons. First, the NLRB held that *Browning-Ferris* exceeded the prior panel’s statutory authority. The NLRB concluded that it is bound by the common law definitions of “employer” and “employee,” definitions that have existed for hundreds of years. In expanding the common law definition of employment to extend to incidental relationships that have some bearing on employment conditions, the *Browning-Ferris* standard impermissibly changed the definition of employment to include relationships that existed at the time that Congress passed the NLRA, yet were excluded from the definitions. Indeed, the standard articulated by the board in *Browning-Ferris* was similar to the “economic realities” test adopted by the Supreme Court in 1944 and subsequently rejected and replaced by Congress in 1947. Because only Congress has the ability to change the definition, the NLRB exceeded the scope of its authority in *Browning-Ferris*.

Second, the NLRB held that *Browning-Ferris* distorted past precedent by implying or suggesting it was returning to the applicable pre-1980 joint employment standard. The *Browning-Ferris* decision cherry-picked past precedent that found joint employment relationships in situations where the third party exercised indirect control over the terms and conditions of the employee’s employment. In those cases, the determining factor was not the indirect control over the terms and conditions of employment, but rather that the indirect control evidenced direct and immediate control. Specifically, in many of the prior cases relied upon by the *Browning-Ferris* board, the retained indirect control was actually exercised by the third party. Moreover, none of the post-1980 cases had been criticized or rejected for requiring immediate and direct control, rather than mere retained or indirect control. As a result of these perceived distorted citations to the record, the *Browning-Ferris* standard had to be rejected.

Third, the NLRB concluded that the vague and overly broad test in *Browning-Ferris* would necessarily result in labor instability and uncertainty. The multi-factor analysis would result in extreme unpredictability in results because every proposed joint-employment situation would require a fact-intensive review. One of the purposes of the NLRA is to promote stable
bargaining relationships, so as to allow employers to reach employment decisions without fear that those decisions will later be deemed an unfair labor practice, and to allow unions to discern the limits of their reach. Under *Browning-Ferris*, neither employers nor unions will be able to discern who the proper bargaining units are, how various joint employment relationships will allow for bargaining (when there are multiple bargaining parties at every table), or how many labor contracts must be bargained if employees are subject to multiple joint employment relationships. In short, there are a multitude of practical problems that make the *Browning-Ferris* standard unworkable, thereby undermining a central purpose of the NLRA.

Fourth, related to the issue of uncertainty, the *Browning-Ferris* rule put thousands of business relationships, chief among them franchises, at risk of being recharacterized as joint employment. These business relationships were formed with the understanding and expectation that they would not qualify as joint employment relationships, and they accounted for hundreds of billions of dollars of annual economic activity, and 3.4 percent of gross domestic product. Moreover, many of the indirect indicia of control are always present in franchise relationships because franchisors need to control and police the use of their trademarks, a requirement of the Lanham Act. The ruling would be highly disruptive to a large slice of the U.S. economy and subject franchise relationships to joint employment for mere trademark licensing, a result Congress did not intend.

Finally, the NLRA includes protections for businesses from secondary economic protest activity, such as strikes, boycotts, and picketing. These protections prohibit unions from using secondary protests as a way of coercing their employer to comply with their labor demands. These prohibitions do not apply to the primary employer or to a joint employer. The expansive definition in *Browning-Ferris* for joint employer would eviscerate these secondary economic protest protections by sweeping related entities into the primary employer definition. Taken to its extreme, individual homeowners could be labeled joint employers under a residential renovation contract and face pickets when leaving their homes. These potentially absurd results are not a reasonable or proper reading of the NLRA.

Notwithstanding the complete repudiation of the *Browning-Ferris* standard, the NLRB found that Brandt and Hy-Brand were joint employers under the prior standard. As a result of Terence Brandt’s direct involvement in hiring and setting company policies at both businesses and the shared employment policies and benefit plans, the NLRB found that both companies exercised direct and immediate control over the terms and conditions of employment. As the control was actually exercised, and not merely reserved, the NLRB held that the judge’s joint employment determination was proper, notwithstanding that it rejected the *Browning-Ferris* standard.

As an editorial post-script to this decision, on February 26, 2018, the Board vacated its decision in *Hy-Brand* after the NLRB’s Designated Agency
Ethics Official issued a report concluding that NLRB board member William Emanuel should have recused himself from participating in the decision. Emanuel’s former management-side law firm, Littler Mendelson, had represented one of the clients in the overturned *Browning-Ferris* decision, thereby creating a conflict of interest for Emanuel that should have triggered his recusal. By vacating the decision, the NLRB reinstated the *Browning-Ferris* standard, at least for the time being.


The Oregon Court of Appeals held that the franchisor did not meet its burden of showing that its franchisees were independent contractors and, thus, the franchisor was responsible for assessments of unemployment insurance taxes by the Oregon Employment Department. The court held that the franchisor could specify results, but could not direct and control the means and manner of providing services without losing the franchisees’ status as an independent contractor. The principal factors that establish the right of control for determining an independent contractor are: (1) direct evidence of the right to or the exercise of control; (2) the method of payment; (3) the furnishing of equipment; and (4) the right to fire.

Here, the franchisor negotiated the services to be provided, as well as the frequency and time period of services. The franchisor also controlled the tools of the trade, requiring certain equipment and supplies of certain brands and types. The franchisor required training for all levels and provided materials and manuals on approved techniques. The franchisees had to take tests to show that they succeeded in applying the techniques and their adoption of the techniques was an implied prerequisite to work. Thus, the franchisor failed to establish that the franchisees were independent contractors because the franchisees were not free from direction and control over the means and manner of performing services.

**NONCOMPETE AGREEMENTS**


The U.S. District Court for the District of Colorado denied the defendant franchisee’s Federal Rule of Civil Procedure 12(b)(6) motion to dismiss, finding that the franchisor of an in-home care business had sufficiently pleaded a claim for breach of a noncompete covenant. The owner of the franchisee (Navin) had executed a personal guaranty of the franchise agreement in which she agreed to be bound by the noncompete provisions contained in the agreement. Navin then started Prominent Home Care, Inc.,
which signed the franchise agreement and a nondisclosure/noncompetition agreement with the franchisor. Notwithstanding, after the franchise agreement expired, Navin started a company that directly competed with Home-watch in the in-home care industry.

Navin argued that she was not personally bound by the noncompetition provisions because she signed in her official capacity as sole shareholder and officer of Prominent Home Care. The court rejected this argument because Navin had signed a guaranty in which she agreed to be personally bound by all provisions in the agreement, including the noncompetition provision. The court found that this language was clear and unambiguous. The court also found that the franchisor had sufficiently alleged that, although there is a general prohibition on noncompetition covenants, the franchise agreements were exempt because they arose out of a business purchase or sale.

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

**STATUTE OF LIMITATIONS**

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

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

This case is discussed under the topic heading “FTC Franchising Rule.”

**STATUTORY CLAIMS**

_Sun Aviation, Inc. v. L-3 Comme’ns Avionics Sys., Inc., Bus. Franchise Guide (CCH) ¶ 16,062, 533 S.W.3d 720 (Mo. 2017)_
This case is discussed under the topic heading “Termination and Nonrenewal.”

This case is discussed under the topic heading “Choice of Law.”

TERMINATION AND NONRENEWAL


Franchisor American Dairy Queen Corporation (ADQ) filed a motion in limine seeking to exclude evidence of franchisee noncompliance with its brand standards. Specifically, ADQ wanted to preclude a franchisee located in Wisconsin (Universal) from arguing that it could not be bound by certain brand standards because ADQ did not regularly enforce its standards with other franchisees at approximately forty other locations in various states. ADQ argued that the other franchisees were not similarly situated to Universal because the other franchisees did not have the same level of noncompliance, the other franchisees did not have the same contract or licensing agreement with ADQ, and some of the franchisees were not located in Wisconsin.

The U.S. District Court for the Western District of Wisconsin agreed with Universal that the evidence of the franchisor’s tolerance of various types of noncompliance was material to the determination of whether these requirements would be considered reasonable and essential under the Wisconsin Fair Dealership Law. The court further found that the evidence of noncompliance by franchisees both in and outside of Wisconsin was relevant to a jury’s determination of whether the termination of Universal was for good cause. The district court did, however, reserve judgment as to whether Universal could rely on this evidence to establish its termination was discriminatory.


Buffalo Wild Wings (BWW) filed several claims in the U.S District Court for the Northern District of Ohio against the defendant, owners of the only restaurant in BWW’s franchise system that operated as a licensee of the franchisor rather than as a franchisee or being directly owned by the franchisor. Instead of waiting for a judicial determination on these claims, the defendant abandoned the license agreement and de-branded its store, remodeled it, and opened under a different name. Both parties then asserted a litany of claims. Both sought a declaratory judgment that the trademark license agreement could be terminated and alleged claims for trademark infringement and unfair competition. The defendant counterclaimed, alleging wrongful termination of the license agreement and breach of contract on the ground BWW had failed to offer it a right of first refusal before opening BWW restaurants in surrounding counties.
The court refused to rule *sua sponte* on BWW’s claim seeking declaratory judgment that the trademark license agreement could be terminated. In its claim, BWW sought a declaratory judgment that the license agreement was valid and enforceable. BWW contended that the defendant materially breached the agreement because it refused to remodel its restaurant and was insolvent and therefore BWW was entitled to terminate the agreement. Although the court conceded that BWW would likely prevail on this claim, neither party asked the court to construe the contract and/or to grant summary judgment.

The court granted summary judgment in favor of BWW on the defendant’s wrongful termination claim because BWW had not terminated the agreement. Rather, the defendant chose to voluntarily abandon the agreement in light of the potential for Lanham Act damages; this did not mean that BWW was responsible for the termination.

The court also refused to grant summary judgment on BWW’s claim for trademark infringement because there was a question of fact regarding whether the defendant’s use of the trademark was without BWW’s consent and whether the unauthorized use likely caused confusion as to the origin or sponsorship of the product.

The court granted summary judgment in favor of BWW on the defendant’s counterclaim that BWW had failed to offer it the right of first refusal because the court found that most of the defendant’s claims were time-barred by the fifteen-year statute of limitations for claims for a breach of right of first refusal. As to the claims concerning the two restaurants that did fall within the statute of limitations, the court found that the defendant had no admissible evidence showing that the plaintiff failed to offer it an ownership interest in specific stores.


The U.S. District Court for the District of Connecticut granted the franchisor of veterinarian clinics summary judgment on its claim that the defendant franchisee (Robb) violated the franchise agreement; the franchise agreement could be immediately terminated due to his violation of the Connecticut Unfair Trade Practices Act (CUTPA). The Connecticut Board of Veterinary Medicine found that Robb had violated state law by administering half-doses of rabies vaccines to animals. The state board issued its final decision on February 1, 2017, and placed Robb’s license to practice veterinary medicine on probation for twenty-five years.

The franchisor sought to terminate Robb’s franchise, arguing that the finding by the state board was a violation of CUTPA. The franchisor asserted that issue preemption prevented Robb from re-litigating the Board’s determination in the franchise context. The district court noted that issue preclusion applies when an issue has been fully and fairly litigated, was actually decided, and the decision was necessary to the judgment. The district court

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court found that all of these criteria were met and therefore granted the franchisor’s motion for summary judgment.


This case concerned five franchisees operating under agreements with the franchisor Advantage Payroll Services, Inc. Each of the franchisees signed a franchise agreement with a ten-year initial term and an option for an additional ten-year extension at the end of the initial term. All of the franchisees exercised their options and extended their agreements for the full ten-year period provided by the option. At the expiration of the option term, the franchisees sought to renew their franchise agreements for an additional ten-year term. When the franchisor refused on the ground there was no contractual right to renew the agreements, the franchisees brought an action seeking a declaratory judgment that that they were entitled to another renewal of their respective franchise agreements. The franchisor filed a motion for partial summary judgment, seeking dismissal of the franchisees’ claims for declaratory judgment.

The U.S. District Court for the District of Maine granted the franchisor’s motion. The court held that the contract terms unambiguously provided for only a single ten-year extension to the initial term. The renewal addenda to the contracts and the initial franchise agreements both contained specific expiration dates. Moreover, although the initial term expiration noted that expiration was contingent on other terms of the contract (e.g., the option), the renewal addenda did not contain any conditional language, clearly indicating that the franchise agreement would expire by its natural terms. The court rejected the franchisees’ request to imply a renewal option in the agreement because that would be contrary to the express language of the contract. Moreover, to do so would create a perpetual franchise with an infinite right to renew the franchise agreement, which the court concluded was an unreasonable interpretation of the agreement.


After the termination of its franchise agreement, a franchisee brought suit against its franchisor alleging that the post-termination noncompete provision of the franchise agreement was unreasonable and unenforceable. The court applied the “rule of reason” test to determine if the noncompete clause would suppress or even destroy competition, rather than promote competition. Under the rule of reason test, the party challenging a noncompete must show that the contract “produced adverse anticompetitive effects within relevant product and geographic markets.”

The court emphasized that even assuming the franchisee showed that it suffered an individualized injury as a result of the noncompete, the relevant
inquiry for the rule of is reason is the protection of competition, not compet-
itors. Accordingly, the court denied the franchisee’s motion for partial sum-
mary judgment, finding that the franchisee had failed to show the covenant
produced adverse anticompetitive effects within the relevant product and
geographic markets. Instead, the franchisee’s evidence tended to show
healthy competition among pizza restaurants in the relevant geographic area.

Sun Aviation, Inc. v. L-3 Commc’ns Avionics Sys., Inc., Bus. Franchise
Guide (CCH) ¶ 16,062, 533 S.W.3d 720 (Mo. Oct. 31, 2017)
This case arose from a manufacturer’s (L-3) termination of a distributorship
relationship without ninety days’ notice to the distributor (Sun) as required
by the Missouri Franchise Law. Sun also alleged that L-3 terminated the agree-
ment without good cause in violation of the Missouri Industrial Maintenance
and Construction Power Equipment Act and that L-3 improperly refused to
repurchase excess inventory following the termination. The circuit court
agreed with Sun and granted partial summary judgment on the issue of liability
on all three claims. The case proceeded to trial on the issue of damages and on
a fourth claim for fraud. On the fraud claim, Sun contended that L-3 had a
duty to disclose that it had plans to consolidate with a parent corporation.
After trial, the court entered judgment in favor of Sun on all counts. L-3 ap-
pealed, and the case was taken up by the Missouri Supreme Court.

On appeal, L-3 argued that it did not provide industrial equipment, and
thus neither of the laws regarding industrial equipment and repurchase
was applicable. The court agreed, reversing the judgment and finding that
the gyros and power supplies the franchisee distributed did not fall under
the phrase “industrial, maintenance and construction power equipment”
for purposes of claims under the Industrial Maintenance and Construction
Power Equipment Act and Inventory Repurchase Act.

The court also reversed the fraud judgment, holding that there was no
duty to disclose parent consolidation plans on the part of L-3. The mere ac-
knowledgment of “trust and confidence” between the parties in an ordinary,
arm’s-length business relationship was insufficient to give rise to the duty to
disclose a material fact that accompanies a fiduciary relationship.

Finally, the court held that the plain language of the notice statute sug-
gested a required causal connection between “the failure to give notice”
and “damages sustained” such that damages arise only during the notice pe-
riod when notice is not given. Thus, the award of eighteen months lost prof-
its to the franchisee was reversed. Ultimately, the court remanded to con-
sider the damages during the ninety-day notice period.

Tim Hortons USA, Inc. v. Singh, Bus. Franchise Guide (CCH) ¶ 16,067,
Case No. 16-23041-CIV-GOODMAN, 2017 WL 4837552 (S.D. Fla.
Oct. 25, 2017)
Plaintiff franchisor Tim Hortons USA, Inc. alleged that the defendant fran-
chisee breached the franchise agreement by failing to timely pay money
owed under the agreement. The U.S. District Court for the Southern Dis-
trict of Florida held that the franchisee’s failure to pay was a material breach
because Florida law provides that failure to make a timely payment consti-
tutes a material breach when time is of the essence. Time is of the essence
when, among other things, the agreement so specifies and when notice has
been given to the defaulting party requesting performance within a reason-
able time. In this case, both conditions had been satisfied because the agree-
ment contained the relevant language and the franchisor had requested per-
formance. Because failure to pay constituted a material breach of the
franchise agreement, the franchisor was entitled to terminate the franchise
agreement pursuant to its terms.

The franchisee offered several arguments in its attempt to sway the court.
First, the franchisee argued that the franchisor could not terminate the fran-
chise agreement because the franchisee made an offer to pay the past-due
sums owed. The court rejected this argument because the franchisee did
not make a legitimate offer to pay; thus, there was no legal tender. In Florida,
legal tender means the actual production of the sum due, not a mere offer to
pay. In addition, the franchisee’s offer to pay happened after the time to cure
passed.

Next, the franchisee argued that the notice of default was defective
because it allegedly included an incorrect default amount. The court
held that even if the notice of default amount was incorrect, the fran-
chisee was still required to substantially comply with the notice of default.
Moreover, the court held that the amount in the default notice was not
incorrect.

The franchisee also argued that the franchisor waived its right to declare a
default because the franchisor withdrew a payment from the franchisee fol-
lowing default. However, the court held that the non-waiver provision in the
contract, which permitted the franchisor to accept payment after default
without waiving its rights, was valid and enforceable. Thus, waiver and es-
toppel did not apply as a matter of law. In addition, the payment that the
franchisor accepted was a payment for current royalties and current advertis-
ing, not the past due amounts.

The franchisee was also unable to show that a course of conduct argument
prevented the franchisor from declaring default because the franchisee had
express payment obligations in the contract. In Florida, the course of dealing
argument applies only to an ambiguous contract.

TRADEMARK INFRINGEMENT

(CCH) ¶ 16,081, 2017 WL 5467156 (N.D. Ohio Nov. 14, 2017)
This case is discussed under the topic heading “Termination and Nonrenewal.”
The U.S. District Court for the District of Nevada granted the plaintiffs’ emergency ex parte motion for a temporary restraining order without notice to prevent the improper use of the plaintiffs’ trademark and the misappropriation of their trade secrets. The plaintiffs alleged that former consultants improperly obtained confidential information from the plaintiffs’ computers and fraudulently seized control of a domain name containing the plaintiffs’ trademark in order to prevent the use of the plaintiffs’ website. They also alleged the consultants had sent a defamatory email under a fake email address. Based on these facts, the court found the plaintiffs were likely to succeed on their claims for cybersquatting and misappropriation of trade secrets. The court held the defendants’ actions would irreparably harm the plaintiffs without the issuance of a TRO. Additionally, the court found the balance of harms and public interest favored the plaintiffs because it would maintain the status quo and promote the protection of trademark rights and trade secrets. The court issued the order without notice to prevent the destruction of evidence or retaliation from the consultants. However, the court declined to grant a TRO as to the plaintiffs’ defamation claim because the plaintiffs failed to prove the named defendants sent the allegedly defamatory email.

The court’s order also addressed two expedited discovery requests. As to the first, it allowed the plaintiffs to subpoena Google to identify the person who created the email address that sent the allegedly defamatory email. As to the second, the court denied the request to subpoena GoDaddy.com regarding the defendants’ seizure of the plaintiffs’ website because the plaintiffs failed to show why expedited discovery was necessary on this matter. Finally, the court found it did not have personal jurisdiction over one of the named defendants because the plaintiffs failed to show he had sufficient contact with Nevada.

The U.S. District Court for the Western District of Texas denied a motion for a preliminary injunction by Stockade Companies, LLC against one of its former franchisees. Stockade owns and licenses trademarks for a group of restaurants. In an earlier, related case, the court granted in part Stockade’s motion for preliminary injunction against the defendant, seeking an order directing defendant to de-brand its “Sirloin Stockade,” “Coyote Canyon,” and “Montana Mike’s” franchise restaurants within twenty-one days. After entry of the order, the defendant rebranded the restaurants as “Kansas Buffets.”

In this case, Stockade sought an order enjoining the defendant from operating “family-style buffets” at former Stockade restaurants and to specifically enjoin defendant from (1) using Stockade’s confidential information
in violation of the parties’ franchise agreements, (2) misappropriating Stockade’s trade secrets in violation of the Texas Uniform Trade Secrets Act, and (3) infringing on Stockade’s trade dress in violation of the Lanham Act.

The court denied the motion for preliminary injunction on the first claim because Stockade’s allegation that the defendant’s restaurants were serving food based on Stockade’s recipes was based on speculative assertions. For example, Stockade employees asserted in conclusory fashion that the recipes were the same because the food tasted the same as food served at Stockade-branded restaurants. The court also rejected the contention that the defendant was improperly using Stockade’s confidential information simply because defendant’s restaurants ran similar promotions, such as “specialty nights,” and had layout and décor similar to Stockade’s restaurants. Stockade had no direct evidence that the defendant used confidential information.

In its second claim, Stockade alleged that its “buffet system” constitutes “protectable trade secrets under Texas Law.” The court denied the motion for preliminary injunction as to this claim because, even if the laundry list of buffet system elements constituted a “trade secret,” Stockade must still show that defendant acquired the trade secret through a breach of confidential relationship or discovered it by improper means. The court held that Stockade failed to meet this burden.

Finally, the court denied the motion for preliminary injunction on the third claim because Stockade failed to establish that the mark or trade dress qualified for protection and that the defendant’s use of the trade dress created a likelihood of confusion in the minds of potential customers as to the source of the goods or affiliation or sponsorship with Stockade’s businesses, because Stockade failed to submit sufficient evidence of defendant’s décor and operations to prove this.

TRADE SECRETS

This case is discussed under the topic heading “Trademark Infringement.”

This case is discussed under the topic heading “Trademark Infringement.”

TRANSFERS

This case is discussed under the topic heading “FTC Franchising Rule.”
UNFAIR COMPETITION/UNFAIR AND DECEPTIVE PRACTICES

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

VICARIOUS LIABILITY

The U.S. District Court for the Western District of Pennsylvania denied a motion to dismiss filed by Midas International Corporation, Midas, Inc., and TBC Corporation (Midas), finding that the plaintiff, an employee of a franchised Midas location, had pleaded a plausible theory of liability for sexual harassment, discrimination, and retaliation under a joint employer liability theory. When examining the plaintiff’s claims for joint employer liability, the court considered three factors: (1) the alleged employer’s authority to hire and fire employees, promulgate work rules and assignments, and set conditions of employment; (2) the alleged employer’s day-to-day supervision of employees, including employee discipline; and (3) the alleged employer’s control of employee records.

Regarding the first factor, the court found Midas had the authority to and did promulgate work rules for its franchisees by requiring franchisees to comply with Midas’s policies on sexual harassment. As to the second factor, the court found the franchisor had the authority to exercise daily control over franchisee employees based on broad language in the franchise agreement, including provisions requiring training and inspections to ensure compliance with the franchisor’s policies. Thus, the court concluded the plaintiff had made at least a weak showing for this factor. For the third factor, the court found Midas had the ability to access employee records based on a provision in the franchise agreement allowing Midas to examine the franchisee’s books and records. Although acknowledging that the case was a close call, the court concluded the plaintiff had pled sufficient facts to survive the motion to dismiss.

The court further found the plaintiff had pleaded sufficient facts to allege vicarious liability based upon broad language in the franchise agreement suggesting Midas had the general power to control the franchisee’s employees and require them to attend discrimination training. Finally, the court rejected the defendants’ argument that they were not liable because they were not signatories to the franchise agreement. The court reasoned that the defendants’ influence over the training of franchisee employees was sufficient to allow the plaintiff’s claims to survive at this stage of the proceeding. Thus, the court denied the motion to dismiss.
In this putative class action, the U.S. District Court for the Central District of California granted a motion to dismiss filed by Jackson Hewitt, Inc. and Tax Services of America, holding that the plaintiff's pleadings failed to allege either vicarious or direct liability against the defendants as franchisors. This case arose from a dispute in which the plaintiff alleged that franchisors Jackson Hewitt and Tax Services of America, along with their franchisees, engaged in fraud by manipulating tax returns, secretly opening bank accounts in their customers’ names, and charging undisclosed fees associated with the bank accounts. The plaintiff alleged the franchisors were liable for the fraudulent conduct of their franchisees and their employees.

The court held the plaintiff failed to allege vicarious liability because the pleadings did not allege the required degree of control. Specifically, the court found the plaintiff failed to allege control over the hiring, firing, or fraudulent conduct of the employee who was the alleged bad actor. Instead, the plaintiff’s allegations were limited to control of marketing and other forms of control over the franchisees’ business plans that are typical of a franchise relationship. Because the plaintiff failed to allege that the franchisors had any control over the franchisees’ employees, the court dismissed the vicarious liability claims.

Likewise, the court dismissed the plaintiff’s claims of direct liability. Because the plaintiff failed to plead that the franchisors had any knowledge of the alleged fraud or otherwise engaged in fraud outside of the fraud allegedly committed by their franchisees, the court held the plaintiff impermissibly grouped both the franchisors and the franchisees together. Thus, the court granted the defendants’ motion to dismiss. But the court also granted the plaintiff leave to amend his pleadings.